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Real Estate Matters

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Introduction

Real Estate Matters constitutes the course materials for 30 hours of continuing education.

The material contains a collection of various brokerage topics, all written to update the reader about ongoing issues that affect California real estate transactions.

Each chapter covers a topic of concern to both brokers and agents. The topics vary to include notes and trust deeds, buyer's contracts and contingencies, disclosure requirements, property management situations and tax and legal aspects. The material is based on current Calfornia law and controlling federal law.

Real Estate Matters was created to enhance the reader's ability to control the results in their real estate transactions.

Chapter 1 — The licensee acts as a principal

This chapter discusses a licensee's lack of duty to disclose his real estate licensee status when acting solely as a principal in real estate transactions.

No duty to disclose the license

An owner of real estate holds a real estate license issued by the Department of Real Estate (DRE).

The owner markets property he owns as "for sale by owner" (FSBO). The owner is not represented by a real estate broker.

A buyer responds to the advertising by contacting the owner regarding his purchase of the property. The owner makes all the necessary disclosures regarding information on the condition of the property, operating data, title condition and location.

The buyer and owner enter into a purchase agreement which is prepared by the owner. The buyer does not know and is not informed the owner is a real estate licensee. Escrow instructions do not contain a licensee declaration provision.

After escrow closes on the sale, the buyer finds the property and the financing incompatible, and also believes he paid too much for the property. Further, the buyer discovers the owner is a real estate licensee.

The buyer attempts to rescind the transaction, claiming the owner, acting solely as a seller, breached his duty to the buyer to disclose he was a licensee and protect the buyer's interests in the purchase.

Two issues arise. First, did the owner, selling property he held for his own account, at any time act as an agent for anyone in the transaction?

No, the owner never undertook an agency relationship with anyone in the transaction. A licensee acts as an agent when he represents *another person*. A licensee cannot act as an agent for himself; it is a legal impossibility. [Calif. Civil Code §2295]

If a licensee represents both himself and the other party in a sales or a loan transaction, he is acting as both:

- a principal for his own account; and
- an agent for the *other principal* in the transaction.

However, the owner did not act in his capacity as a licensee and did not represent the buyer (or others) with the expectation of compensation, nor did he hold himself out as a licensee, much less the buyer's agent in the transaction.

The second and more germane issue is whether the owner, acting only as a principal, has a duty to disclose his status as a real estate licensee (or as holder of any other professional license) when he markets and sells his own real estate to a buyer?

No! A principal's duty, when acting as a seller, is to disclose sufficient information to place the buyer on notice of property conditions which are not observable by the buyer and are known to the seller. The

status of the property, not the seller's status (as a licensee), delimits the disclosures. The buyer is acquiring real estate, not the agency obligations or services of a licensee.

A conflict does not arise when a real estate licensee sells property he owns unless he acts in the capacity of an agent on behalf of another. And, to advertise property for sale as an "owner/agent" is a contradiction, an absurdity, and confusing to a buyer. No agency exists with anyone at the time of the advertising.

A principal-licensee conflict requiring additional disclosures only arises when:

- the licensee represents the buyer or seller as an agent; and
- the licensee has or will have a direct or indirect interest in the property sold or bought.

Agent's duty to disclose interest in property

When *acting as a licensee* in a real estate transaction, a real estate broker has a general agency duty to disclose to all the principals involved whether:

- the broker has or is acquiring for his own account a direct or indirect interest in the property [**Whitehead** v. **Gordon** (1969) 2 CA3d 659];
- the broker's agent or employee has or is acquiring for his own account a direct or indirect interest in the property; or
- a relative of the broker or the broker's employee has or is acquiring an interest in the property. [**Sierra Pacific Industries** v. **Carter** (1980) 104 CA3d 579]

Editor's note — While negotiating a transaction on behalf of others as a real estate agent, a licensee who fails to disclose he is acquiring or selling an interest in the real estate, directly or indirectly, may find his license revoked by the DRE. [**Buckley** v. **Savage** (1960) 184 CA2d 18]

Agent disclosure of entrepreneurial benefits

Now consider a seller of residential property who lists the property with a real estate broker.

The broker locates an investor who is interested in the property as well as other properties. The broker acts as the investor's agent regarding all these properties. The broker prepares an offer to purchase the property listed for less than the seller's listing price.

The broker delivers the investor's written offer to the seller, which discloses the broker's dual agency.

The seller balks at the lower sales price. The broker discourages the seller from making a counteroffer by informing him the investor will not agree to pay a higher price in the current market.

The seller follows the broker's advice and accepts the investor's offer.

On close of escrow, the broker enters into an exclusive listing agreement with the investor to resell the property for a listing price exceeding the seller's original listing price.

After escrow closes, the seller learns the property has been resold by the broker at a higher sales price.

The seller claims the broker breached his agency duty by intentionally failing to disclose the broker's personal interest to negotiate a lower sales price so the property could be promptly resold by the broker on behalf of the investor.

The broker claims he did not breach his agency duty since the seller was fully aware he was a dual agent.

Did the broker fail to disclose a material fact to the seller and thereby breach his duty as a dual agent?

Yes! The broker failed to disclose an agency conflict to the seller which was a material fact — the broker's personal expectation of a future business opportunity with the investor regarding the relisting and resale of the subject property. The seller might have bargained for a more favorable sales price or refused to counter at all had he been aware of the broker's entrepreneurial arrangement with the investor regarding an indirect interest in the property. [**Jorgensen** v. **Beach 'N' Bay Realty, Inc.** (1981) 125 CA3d 155]

Acting as a real estate licensee

A person acts as a real estate licensee when he:

- negotiates the sale or purchase of property on behalf of another person; and
- expects to be compensated for his work. [Calif. Business and Professions Code §10131]

If **the licensee** is involved in a transaction, but is not acting on behalf of a principal, the licensee is selling, buying, leasing or financing real estate for his own account and is merely a principal in the transaction — unless the licensee leads the other party to believe he is that party's agent.

An agent is a person authorized by another, called a principal, to:

- negotiate a transaction with a third person; and
- exercise a degree of discretion in meeting the principal's objectives. [**L. Byron Culver & Assoc.** v. **Jaoudi Industrial & Trading Corp.** (1991) 1 CA4th 300]

Creating an agency liability where none exists

The fact a seller or buyer of real estate holds a real estate license is irrelevant to their sales transaction. No seller or a buyer needs a license to act as a principal. More importantly, the seller or buyer need only have a license if they are also acting on behalf of (representing) someone else in the sale, a requisite for establishing an agency.

However, when the seller or buyer negotiates the sale or purchase of real estate for his own account and includes payment of a brokerage fee to himself, the seller or buyer is also holding himself out as a broker who is negotiating the transaction. Once the owner authorizes the payment of a fee to himself as a broker, a fact known to the other party, the broker has undertaken the general duty to honestly disclose and advise on the condition of the property, title, expenses and location to the seller or buyer. [**Prichard** v. **Reitz** (1986) 178 CA3d 465]

Editor's note — When a licensee is a buyer or seller of his personal residence or investment properties, building a fee into the real estate transaction also produces an adverse income tax result.

When an owner takes a brokerage fee on a sale, the profit taken becomes skewed; part profit, part personal income. If, on a purchase the buyer takes a credit for a brokerage fee on the price paid, the fee must be declared as personal income in the year of the transaction, not as part of the basis in the investment or business asset acquired. Thus, the federal rate of taxation applied is up to 39.6%, payable now, and not limited to 20%, payable on a later resale.

Consider a licensee who acts solely as the seller or buyer and conducts himself in a manner which leads the other principal to believe the licensee is also acting as his agent in the transaction. Agency conduct includes an assurance to the buyer that the transaction will be handled properly since the seller is a real estate licensee. Thus, he is deemed the agent of the other party, since he disclosed his licensee status and also used the license to his advantage in negotiations. [**In re Woosley** (9th Cir. BAP 1990) 117 BR 524]

Licensee is still the seller

When a licensee sells property he owns, holding himself out only as the seller, the licensee is required to make only the disclosures required by any seller of real estate. For instance, if the property is a one-to-four unit residence, the seller must complete and hand the buyer a Condition of Property Statement as well as a hazard disclosure. [CC §1102.3]

The seller also is required to disclose all material facts he knows or should have known as the seller of the property, even though he is not acting as a licensee on behalf of the buyer while negotiating the transaction. [**Easton** v. **Strassburger** (1984) 152 CA3d 90]

A *material fact* is any information known to the seller **about the real estate** which might affect the buyer's decision to purchase the property. [**Ziswasser** v. **Cole & Cowan, Inc.** (1985) 164 CA3d 417]

Other professionals whose services are real estate related, such as attorneys, loan officers, escrow officers, title officers and CPAs, are likewise not compelled to disclose their professional licensee status when acting solely as a principal in a real estate transaction.

While a real estate licensee is in the profession of negotiating the sale, leasing or financing of real estate, the licensee's profession and the expertise gained as a licensee does not impose on him a special duty to disclose his real estate licensee status when buying and selling property for his own account.

It is the converse activity which must be disclosed — when acting as an agent, you must disclose if you are somehow involved, related or affiliated with a principal.

Real estate licensing does not create a second rate citizenship when the licensee buys or sells on his own account, even though most escrow officers drafting escrow instructions see it that way and automatically include a licensee declaration.

Chapter 2 — Brokerage activities: agent of the agent

This chapter introduces the concept of a licensed real estate agent being an agent and either an employee or independent contractor of a licensed real estate broker.

For, on behalf of and in place of

Historically, as brokerage services in the mid-20th century became more prevalent in California and the public demanded greater consistency and competence in the rendering of these services, the state legislature began standardizing and regulating:

- who could become licensees and offer brokerage services;
- the duties and obligations owed by the licensees to members of the public; and
- the procedures for soliciting and rendering services while conducting licensed activities on behalf of clientele.

The resulting legislation and regulations which now control the brokerage services provided on the sale and purchase of real estate are straightforward and uncomplicated. Collectively, the standards set the minimum level of conduct expected of a licensee when dealing with the public, such as **competency and honesty**. The key to implementing these professional standards is the **education and training** of the licensees.

Individuals who wish to become real estate brokers are issued a broker license by the Department of Real Estate (DRE) only after completing extensive, additional real estate related course work and meeting minimum on-the-job experience requirements. On receiving the license, a broker is presumed to be competent in his skill and diligence, with the expectation that he will conduct himself in a manner which rises above the minimum level of duties owed to clientele and other members of the public.

Therefore, the individual or corporation which a buyer or seller, landlord or tenant, or borrower or lender retains to represent them in a real estate transaction may only be a licensed real estate broker.

To retain a broker to act as his real estate agent, the buyer or seller enters into an employment contract with the broker, called a *listing agreement*.

Broker vs. sales agent

Brokers are in a distinctly different category from sales agents. Brokers are authorized to deal with **members of the public** to offer, contract for and render brokerage services for compensation, called *licensed activities*. Sales agents are not. [Calif. Business and Professions Code §10131]

A real estate salesperson is strictly an agent of his employing broker. An agent **cannot contract in his own name** or on behalf of anyone other than his employing broker. Thus, an agent cannot be employed by any person who is a member of the public. This is why an agent's license must be handed to his employing broker, who must retain possession of the license until the agent leaves the employ of the broker. [Bus & P C §10160]

Only when acting as a representative of his broker may the sales agent perform brokerage services which only the broker is authorized to contract for and provide to others, called *clients*. [**Grand** v. **Griesinger** (1958) 160 CA2d 397]

Further, a sales agent can only receive compensation for his real estate related activities from his employing broker. An agent cannot receive compensation directly from anyone else, e.g., the seller or buyer, or another licensee. [Bus & P C §10137]

Thus, brokers are the *agents* of the members of the public who employ them, while a broker's sales agents are the *agents of the agent* who render services for the broker's clients as the broker's representatives. [Calif. Civil Code §2079.13(b)]

As a result, brokers are responsible for all the activities their agents carry out **within the course and scope** of their employment. [**Gipson** v. **Davis Realty Company** (1963) 215 CA2d 190]

Responsibility for continuous supervision

When a broker employs a sales agent to act on behalf of the broker, the broker must **exercise reasonable supervision** over the activities performed by the agent. The broker who does not actively supervise his agents risks having his broker license suspended or revoked by the DRE. [Bus & P C §10177(h)]

Here, the employing broker's responsibility to the public includes:

- on-the-job training for the agent in the procedures and practice of real estate brokerage; and
- continuous policing by the broker of the agent's compliance with the duties owed to buyers and sellers.

The sales agent's duties owed to the broker's clients and others in a transaction are equivalent to the duties owed them by the employing broker. [CC §2079.13(b)]

The **duties owed** to the various parties in a transaction by a broker, which may be carried out by a sales agent under the employing broker's supervision, oversight and management, include:

- the *utmost care, integrity, honesty and loyalty* in dealings with a **client**; and
- the use of *skill, care, honesty, fair dealing and good faith* in dealings with **all parties** to a transaction in the disclosure of information which affects the value and desirability of the property involved. [CC §2079.16]

To insure that his agents are diligently complying with the duties owed to clientele and others, the employing broker must establish **office policies, procedures, rules and systems relating to:**

- *soliciting* and obtaining buyer and seller listings and *negotiating* real estate transactions of all types;
- the *documentation* arising out of licensed activities which might affect the rights and obligations of any party, such as agreements, disclosures, reports and authorizations prepared or received by the agent;
- the *filing, maintenance and storage* of all documents affecting the rights of the parties;
- the handling and safekeeping of *trust funds* received by the agent for deposit, retention or transmission to others;
- *advertisements*, such as flyers, brochures, press releases, multiple listing service (MLS) postings, etc.;
- compliance by his agents with all federal and state laws relating to *unlawful discrimination*; and

- the receipt of regular *periodic reports* from agents on their performance of activities within the course and scope of their employment. [Department of Real Estate Regulations §2725]

One method for implementing the need for supervision is for a broker employing agents to develop a **business model**. With it, the broker establishes the means and manner by which listings are produced and serviced, and how purchase agreements are negotiated and closed by his agents. The development of a plan of operations logically starts with an analysis of the conduct required of an agent by establishing categories of administrative and licensed activities. [See Figure 1 accompanying this chapter]

Categories of business and licensed activities include:

- **administrative rules**, covering a description of the general business operations of the brokerage office, such as office routines, phone management, sign usage, budgetary allocations for agent-support activities (advertising, farming, etc.), agent interviews, goal setting and daily work schedules;
- **procedural rules**, encompassing the means and methods to be used by agents to obtain measurable results (listings, sales, leases, loans, etc.);
- **substantive rules**, focusing on the documentation needed when producing listings, negotiating sales, leases or loans and fulfilling the duties owed by the broker to clientele and others;
- **compliance checks**, consisting of periodic (weekly) and event-driven reports (a listing or sale) to be prepared by the agent, and the review of files and performance schedules by the broker, office manager or assistants, such as listing or transaction coordinators; and
- **supervisory oversight**, an ongoing and continuous process of training agents and managing their activities which fall within the course and scope of their employment.

The rules and procedures established by the broker to comply with his responsibility to manage and oversee the conduct of his agents when they are acting in his place in dealings with clientele and other members of the public must be agreed to in writing with the agents he employs. A **written employment contract** sets forth the duties of the sales agent and the agent's need to comply with an office manual which contains the broker's policies, rules, procedures and other conduct the broker deems necessary to control the fulfillment of his responsibility for supervision.

Also, the written employment agreement must spell out the **compensation** the agent is to receive for representing the broker in soliciting and negotiating listings, purchase agreements, leases and financing. [DRE Regs. §2726]

The (not so) independent contractor

Most sales agents receive compensation from their brokers based on a negotiated percentage of **contingency fees** received by the brokers for completed sales, leases or loans solicited or negotiated by the agents.

Whether state and federal income tax is withheld depends on the type of employment agreement the broker and agent enter into, i.e., an **independent contractor** (IC) or **employee-employer** (EE) agreement.

A sales agent licensed by the DRE and employed by a broker under an independent contractor agreement, who is paid based on the broker's receipt of a contingency fee, **will not be treated as an employee** for purposes of income tax withholding or contributions. [Internal Revenue Code §3508]

The chief advantage for a real estate broker who uses an IC agreement is the simplification of the bookkeeping process. An IC agreement avoids withholding for income taxes or medicare and social security benefits from the agent's fee, while also avoiding employer contributions.

In turn, the broker files a 1099 report with the Internal Revenue Service (IRS) naming each agent and stating the fee amount each received as an employee of the broker under a contingent-fee, IC agreement.

To further simplify disbursement of the agent's share of the fee due from the broker, some brokers instruct and authorize escrow to disburse to the agent, from fees accruing to the broker on the close of a sales escrow, the amount of the fee due the agent from the broker. However, this system of payment leaves the broker without adequate records for 1099 and workers' compensation reporting.

For sales agents entering into an IC agreement, they report their fees received from their broker as business income (Schedule C). In turn, the agent expenses all his business-related costs of operation incurred while acting within the course and scope of his employment with the broker, no matter the degree of control the broker actually exercises over the agent's activities.

However, even though the agreement is called an "independent contractor" agreement, the agent is **still an agent** of his employing broker.

When testing the **conduct** of an agent while engaged in real estate related activities, the IC provision in his broker-agent employment agreement **cannot and will not change** the agent's classification as an agent of his broker under California real estate law. [Gipson, *supra*]

Thus, brokers who use an IC agreement must not be mislead or believe that somehow the agent may permissibly act independent of the broker, or that the DRE will treat the relationship as devoid of control and assertiveness by the broker over the agent's conduct.

Agent imposes liability on broker

Consider a sales agent who is employed by a broker under an IC agreement. The broker gives the agent *total discretion* in his handling of clientele and documentation of listings and sales.

However, the IC agreement includes a provision calling for the agent to deliver to the broker a binder for liability insurance on the agent's car which names the broker as an insured. The IC agreement also requires all documents and funds received on listings and sales to be entered into and taken in the name of the broker, and all advertising and business cards to identify the agent as acting for the broker as an associate licensee.

One day, while the sales agent is driving his car to list a property, he collides with another vehicle, injuring the driver. The driver makes a demand on the agent's broker to pay for the driver's money losses incurred due to the agent's negligence.

The broker rejects the demand, claiming the agent is an independent contractor, not an agent (much less an employee) of the broker, and thus the broker has no (vicarious) liability for the losses inflicted on the driver by the agent.

The driver claims the broker is liable for his losses since the agent is a representative of the broker, acting within the *course and scope* of his employment when the injuries occurred.

Can the driver injured by the agent's negligence recover his money losses from the agent's broker?

Yes! The sales agent is the *agent of the broker* as a **matter of law**, without concern for the type of employment agreement they have entered into.

Figure 1

Forming a business model

Within each category of activity covering the broker's management of his agents' conduct for producing, servicing and negotiating listings and sales, is a list of items to be considered.

Administrative

- E & O insurance
- workers' compensation insurance
- automobile insurance binder
- general comprehensive business insurance
- agent policy manual (on procedural,substantive and compliance activities)
- new agent qualifications and interview procedures
- institutional advertising franchise affiliation
- trade organization membership
- MLS subscriptions
- employment contracts with sales agents
- agent pay, advances, and escrow disbursements
- production goals
- phone/floor-time coverage
- hours/agents' work schedules
- business cards
- storage of documents (3 years)
- office meetings/ attendance
- agent contribution to expenses
- bank trust accounts
- general business bank accounts

Organizational Procedures

- forms to be used
- use of coordinators
- use of office equipment
- use of affiliated services
- use of controlled businesses
- attorney inquiry/ referral to broker
- trust fund handling (deposit and log)
- e-mail content
- public record inspection
- servicing property listings (MLS, signs, ads, property profiles, open houses, correspondence, showings, checklists, rents, etc.)
- servicing buyers (listings, property profiles, broadcasts, wants, showings, qualifying, checklists, etc.)
- client lists and follow up

Substantive Activities

- taking property listings (addenda and disclosure checklists, deposits, property profiles, further approvals, fee setting, seller profiles, etc.)
- preparing offers (documents/disclosures and addenda checklists, duty checklists, advice on use of arbitration, forfeiture, escrow, title, misc. provisions, fee provisions, etc.)
- FSBO submission of offers (fee arrangements, listings, dual agency, etc.)
- preparation of documents, use of attorneys, added provisions

Compliance

- pay contingent on file audit and completeness
- listing logs
- transaction logs
- trust fund logs
- periodic reports
- listing reports
- sales reports
- schedule of report due dates
- other events which trigger notices or reports to management

Supervision

- continuous daily oversight
- constant follow up on compliance with procedures and substantive activities
- instructions on propriety of acts within the course and scope of employment
- degree of enforcement being tight and disciplined, or lax and allowing great discretion
- use of assistants to provide oversight

Further, and in spite of the IC employment agreement allowing total discretion to the agent in the conduct of his handling of listings and sales, the agent is **subject to supervision** by his broker who is required by law to actively conduct his brokerage business. Since the sales agent is an agent of the broker, without regard to their employment agreement, and at the time of the injury was acting within the course and scope of the agency with the broker, the broker cannot escape liability for his agent's negligence. [Gipson, *supra*]

The broker hiring agents who use their own cars to conduct brokerage activities by going to and from appointments, meetings and properties not only needs to be a named insured on the agent's car insurance policy, but also needs to maintain general comprehensive business liability insurance and professional liability coverage (errors and omissions insurance) since tortious conduct of all sorts can arise out of listings and sales transactions solicited and negotiated by their agents.

Thus, supervision is critical to the reduction of the broker's exposure to liability for their sales agents' failure to inspect, disclose, advise and care for clients.

Unemployment insurance benefits

For the purposes of administering **real estate law**, a sales agent is considered both an *agent and an employee* when acting within the course and scope of employment with a broker. [Grand, *supra*]

However, as with state and federal income tax withholding, an agent is not always treated as an employee.

For example, licensed real estate sales agents, as well as real estate brokers, are **excluded employees** for purposes of the California Unemployment Insurance Law. Even though a sales agent is considered both an agent and an employee under California real estate law, a broker does not have to contribute to the state unemployment insurance fund on behalf of the agent. In turn, the agent cannot collect unemployment benefits from the state when he is terminated from the employ of the broker.

Receipt of compensation by a licensed real estate agent under an employment agreement, paid as a *contingency fee* for closing transactions and not based on a per hour amount, is the **only test required** for the broker to avoid paying into and for the agent to be denied unemployment benefits, regardless of the degree to which the broker supervises and controls the agent's real estate related activities. [Calif. Unemployment Insurance Code §650]

Minimum wage exclusion

A sales agent is entitled to payment of minimum hourly wages from a broker if the agent is classified as an *employee* under California labor laws, a technical condition requiring **constant supervision** and **total control** by the broker over the agent's **means, manner and mode** of engaging in activities requiring a real estate license.

However, as *agents* of their broker, most agents have a high level of discretion and control in the setting of their schedules, especially during the hours spent outside of their broker's office.

Typically, the agents' time in the office spent at the updesk, or on the phones or floor, rarely take up more than one day a week, usually less than 20% of the time spent on real estate related listings and sales. Little additional time is spent in the office at staff meetings. As a result, agents are rarely considered employees, except for the purpose of judging their conduct as a licensee under California real estate law.

As an *outside salesperson* who regularly works **more than half** of his time **away** from his place of employment, selling items or obtaining contracts for services, a real estate sales agent is **excluded from collecting a minimum wage** from his broker. [Calif. Labor Code §1171]

Consider an agent who is employed by a broker under an IC agreement. The broker does not have a policy manual, training program or any requirements as to what forms to use and what duties are to be fulfilled by the agent (a dereliction of the broker's duties of supervision). Once a month, the agent reports to the broker by preparing and presenting a transaction log noting the listings and sales activity the agent has been involved in during the month.

After several months of employment and no sales, the broker terminates the agent. During the employment, the broker disbursed funds to the agent as an advance draw against fees yet to be earned by the agent. Any amounts not reimbursed are payable on termination. Thus, by agreement, the broker calls due the amounts advanced and unpaid, and makes a demand on the agent for payment.

The agent claims he is entitled to an offset since he is an employee of the broker and thus entitled to a minimum wage in amounts which exceed the advances received from the broker. The agent makes a demand on the broker for unpaid wages at the minimum rate per hour worked.

Here, the agent demanding a minimum wage must demonstrate that his actual working relationship with his broker was more than just that of an independent contractor or an agent of his broker, but that of an employee under the labor code.

Accordingly, the agent must demonstrate that the relationship he actually experienced while employed by the broker included total control by the broker over every **means, manner and mode of conduct** used by the agent to carry out licensed activities on behalf of the broker, such that the agent was nearly without discretion to operate on his own.

Here, the broker's supervision and management of the agent by implementing policies and procedures for the negotiation of real estate transactions were nearly nonexistent.

While the sales agent was an agent of the broker, the sales agent was not under the *common law control* of the broker as required to establish the agent as a *servant* hired to perform under continuous direction. Thus, the sales agent was not an *employee* for the purposes of the labor law, and therefore could not receive a minimum wage. [CC §2079.13(b); **Grubb and Ellis Company** v. **Spengler** (1983) 143 CA3d 890]

The issue of being excluded from collecting a minimum wage based on the agent being classified as an *outside salesperson* never arose in the *Grubb and Ellis Company* case.

However, even if the broker had controlled the agent's activities, hours, scheduling and production of listings and sales, the agent still would most likely have been outside the office more than half of the hours spent working for the broker. Thus, the agent most likely would have been classified as an employee under the labor law, but would definitely have been **excluded** from collecting a minimum wage due to his status as an outside salesperson.

Workers' compensation coverage for employees

For purposes of workers' compensation insurance, the relationship between a broker and his agents is that of an employer and his employees. As a consequence, all real estate brokers in California **must pro-**

vide workers' compensation insurance coverage for their sales agents. [Lab C §§3200 et seq.; Department of Real Estate Bulletin, Fall 2004, Page 10]

A broker who is illegally uninsured or forces his agents to carry their own workers' compensation insurance may face:

- a **stop order** from the Department of Industrial Relation's Division of Labor Standards Enforcement (DLSE), preventing the broker from conducting business until proof of insurance is offered up;
- **civil penalties and fines** up to $100,000; and
- **claims** from current and former agents seeking reimbursement for premiums they paid. [Lab C §§3700 et seq.]

For a broker who employs one or more agents, he must, by necessity, be covered by workers' compensation insurance, along with business, vehicle and professional liability insurance (errors and omissions coverage). The coverage provides the broker with a financial safety net against agent-imposed liability by shifting the risk of loss to the insurance companies, whether the sales agents are mere agents or also employees.

Thus, the well supervised real estate brokerage business, as owned and managed by a broker who runs a properly conducted operation, provides an enduring professional environment in which their sales agents should flourish.

Chapter 3 Real estate's low-level management of human resources

This chapter comments on the rapid and seemingly wasteful turnover of entrants into the real estate profession.

The entry and exit of agents

In 1999, the Department of Real Estate (DRE) issued original real estate salesperson licenses to 20,410 individuals. By the end of 2003, four years after newly acquiring their licenses, 58% (11,868) of the originally licensed agents in 1999 **no longer participated** as licensees rendering services in real estate transactions on behalf of brokers.

This group of nonparticipating agents either failed to renew (9,203) or renewed as inactive, unemployed licensees (2,665). Thus, of all the agents originally licensed in 1999, **only 42% remain active** in the practice of real estate brokerage.

Now consider the 21,450 original real estate salesperson licenses issued in 2001 by the DRE. By July 2003, only 18 months after the last of the 2001 group of agents received their licenses, 21% (4481) were suspended and no longer engaged in real estate related services. They had failed to complete the basic DRE-mandated educational requirements to retain the use of their sales licenses.

In addition, another 18% (3,805) of this group of licensees from 2001 were inactive by January 2004.

When this 2001 group of newly licensed agents completes their first four-year renewal in 2005, the attrition will likely produce a total dropout rate of 60%. This nearly equals the 65% dropout rate at the end of four years for those agents who came into the real estate business in 1998, and slightly more than the 58% four-year dropout rate for 1999.

In 2003, 40,479 individuals received original real estate salesperson licenses. By the end of 2003, 27% (10,867) were inactive and unemployed as real estate agents.

Thus, when the agents who were originally licensed in 2003 complete their first four-year renewal in 2007, approximately 40% will likely remain active as agents participating in real estate transactions. Some will have become brokers. Another 15% will likely renew their license in an inactive, nonparticipating status, for a total fallout rate anticipated for the licensees from 2003 of 60%.

Solving the dropout problem

The rate of attrition for agents entering the real estate profession suggests that fully one third of the new licensees are not qualified by education, temperament and/or experience. They should not have been licensed or hired in the first place.

Possibly, the attrition is due to the brokerage community's inability or unwillingness to give new licensees the administrative oversight, technical training, structured routine and organizational support necessary to attract and retain individuals seeking to enter the business of real estate services as a life-long profession.

Also, the cyclical nature of boom and bust within the real estate industry, reflected in the number of entrants from year to year, is a factor which only aggravates the turnover rate.

Alternatively, the DRE guidelines may be too permissive, i.e., the threshold to obtain a license may be too low.

Becoming licensed as a real estate agent borders on being a "no-brainer," especially for individuals with a little tenacity. A certificate of completion for a principles course, needed to qualify to take the state exam for licensing, is attained by either attending classes at a real estate school or community college for the requisite 45 hours of attendance, or by completing an equivalent homestudy course and passing a final exam.

However, passing the state licensing exam may require more instruction. Thus, a "boot-camp" style, weekend cram course (or some other equally intense program) designed solely to pass the state exam is needed to supplement the principles course in order for most individuals to pass the state exam. This preparatory course for the state exam is not treated as education since it does not contribute to the competence of the individual for purposes of being a real estate agent.

Therefore, new real estate agents come to the real estate brokerage world without any practical experience and insufficient effective education to assist, much less advise, the clients who retain the services of their broker.

A step in the right direction would be two years of on-the-job training for a new agent as an assistant, sometimes called a *runner*, to his broker or an experienced agent in the office. The agent then learns the ropes under a high-volume agent in the office, or with the office's transaction coordinator.

At some point, the agent's level of competence is sufficient to satisfy the broker to allow them to operate on their own and report directly to the broker or office manager rather than a team leader. Industrial and commercial brokers tend to follow this course of action.

The broker takes charge

To operate a successful brokerage office, the broker must employ viable agents.

It is the quantity and quality of agents that produce the end result sought by brokers to be successful, i.e., brokerage fees.

As in all service businesses, the lynchpin for achieving success is the ability of management to orchestrate the efforts of qualified agents.

However, most brokers employing agents tend not to dedicate much energy to the supervision of their agents. A level of seemingly deliberate neglect prevails in most single-family residential brokerage offices. Thus, agents are left to learn the trade by observation and to hone their skills by trial and error, an empirical result based more on the agents' good instincts than on training, procedural policy and constant supervision.

Brokers need to be more than distant observers limited to providing remote oversight for the agents. They or their administrative assistants and managers must learn to supervise and police the business-related conduct of their agents.

Such conduct includes:

- setting the production goals to be attained (listings and sales);

- an analysis of the agent's income and expenses;
- the setting of fees needed for the agent to become financially viable as a real estate agent;
- establishing the personal routines and activities which will likely make the agent productive, i.e., overseeing the agent's management of time spent working for the broker; and
- the insistence that compliance reports be prepared and delivered periodically to management.

Further, the broker must be actively involved in the agent's fulfillment of the duties owed by the broker to those clients with whom the agent has contact.

Thus, the agent knows from the beginning just what level of production is expected of him by the broker as a requirement for remaining with the office. Also, the broker will be demonstrating his expectation that the sales agent is to maintain a competitive attitude about producing listings and buyers. Further, an environment will have been created with a greater probability of producing purchase agreements and closings, which spells success for all involved.

The myth of "too much control"

A dilatory broker employing sales agents in his residential brokerage business frequently uses as an excuse for his lack of supervision the old, pre-1979 myth that a broker cannot tell an agent what to do, when or where to do it, and the amount of time the agent will spend doing it. As the myth goes, the agents are not employees; they are independent contractors who must operate free from the broker's direction, otherwise some adverse financial, legal or tax result will be visited on the broker.

Agents are employees as a matter of California real estate law. They and their brokers are excluded as *exceptions* from benefits and contributions for unemployment insurance and income tax withholding on the employment of real estate agents.

Minimum wages are only an issue if the agents are desk-bound in the office more than half the time spent working for the broker. The only other employer/employee concern is workers' compensation insurance which every broker employing a sales agent is required to carry.

Should all of the broker's efforts during the apprenticeship and start-up period fail to develop agents who remain in the business, the broker should review why the agents should not have been hired, and if they should have been hired, what would have made them successful real estate agents.

With adjustments by employing brokers in hiring, training and managing their agents, the broker's human resources will become a long-term asset — the arms and legs of his business — not just bodies occupying cubicles and floor space in the office.

Chapter 4 — "For Sale" sign regulations

This chapter discusses a property owner's right to display signs advertising his property "For Sale."

Property owners can display

Consider an owner of a residential unit in a common interest development (CID), such as a condominium project, who places a "For Sale" sign in the window of his unit.

A neighbor in the project complains about the sign to the homeowners' association (HOA) which manages the project. In response, the HOA makes a demand on the owner to remove the sign claiming the sign is a violation of the conditions, covenants and restrictions (CC&Rs) controlling conduct in the project.

Can an owner place a "For Sale" sign in the window of his unit where it can be seen by others when the display is in violation of the HOA's CC&Rs or policy statements?

Yes! Owners of real estate and their brokers have the right to display "For Sale" signs of reasonable dimension and design on their property, or on property owned by others if they have their **consent**, in spite of title restrictions in the CC&Rs. [Calif. Civil Code §712]

The "For Sale" sign displayed on the property being sold by the owner or his agents, or displayed on other private property with that owner's consent, may contain:

- advertising stating the property is for sale, lease or exchange;
- directions to the property;
- the owner's or agent's name; and
- the owner's or agent's address and telephone number.

However, the sign or location of a "For Sale" sign must not adversely affect public safety or impede the safe flow of vehicular traffic.

Further, any local governmental ordinance which attempts to **bar or unreasonably restrict** the placement of a real estate "For Sale" sign on the property for sale, or private property owned by others who have consented to the placement of a directional "For Sale" sign on their property, is unenforceable. [CC §713]

Reasonably located on-site signs

"For Sale" signs may be reasonably located in plain view for the public to observe. [CC §§712, 713]

For example, in a CID, the boundaries of a unit owned as the separate interest of a member of the CID are the walls, windows, floors and ceilings. If the CC&Rs of the CID do not state otherwise, the interior surface of the perimeter walls, floors, ceilings, windows, doors, outlets and airspace located within a unit are considered the owner's separate interest. All other portions of the walls, floors, ceilings and real estate are part of the common area maintained and managed by the HOA. [CC §1351(l)]

Thus, the owner is entitled to display a "For Sale" sign on the **interior side** of the window of his condominium unit. The interior side of the window belongs to the owner and placing of the sign in the window is reasonable.

However, if the owner seeks to display the sign on the exterior wall or ground area surrounding his unit, the owner must obtain the permission of the HOA since the exterior walls and ground area are part of the common area, **owned by others**, specifically, the undivided ownership interest held by all the owners of units in the CID or the HOA. [CC §712]

Reasonable restrictions

Now consider a city which prohibits the display of all "For Sale" signs to stop perceived white-flight from a racially integrated city.

A property owner and his listing agent claim the ban is an unconstitutional interference with real estate sales, called a *restraint on alienation,* and violates the owner's freedom of speech.

The city claims the sign prohibition is constitutional since it does not prohibit other ways in which to advertise property for sale, only those advertisements located on the property.

Is the city ordinance a reasonable restriction on the display of "For Sale" signs?

No! Prohibiting the display of "For Sale" signs is a violation of the First Amendment freedom of speech right since other methods of advertising real estate for sale are less effective and the ordinance prohibits the free flow of truthful commercial information. [**Linmark Associates, Inc.** v. **Township of Willingboro** (1977) 431 US 85]

Further, cities and counties may not prohibit the placement of "For Sale" signs on private property, be it the property to be sold or property owned by others who consent to a directional sign being placed on their property. However, government agencies may determine the location, shape and dimensions of "For Sale" signs to ensure the signs do not affect public safety, including traffic safety. [CC §713]

Cities and counties restrict the display of "For Sale" signs on private property through ordinances, nuisance laws or building requirements. Restrictions may vary between residential and industrial zones, and among cities. Copies of "For Sale" sign ordinances controlling their use on private property are available through the city and county planning departments.

Additionally, HOAs cannot prohibit owners of units in a CID from displaying "For Sale" signs within the owner's separately owned land areas if the sign complies with state law and local ordinances. [CC §712]

A copy of a HOA's governing documents and CC&Rs controlling the dimensions and design of "For Sale" signs are available from the HOA.

Signs on right-of-ways and alongside public highways

The display or placement of a "For Sale" sign on a private or public right-of-way, such as roadways, may be limited or regulated by local government agencies. [CC §713]

Further, a directional sign advertising real estate for sale, lease or exchange that is located on property other than the property advertised for sale and visible from a highway which is subject to the federal Highway Beautification Act requires a **special permit** be obtained from the Director of Transportation

of the State of California before the sign may be erected. [Calif. Business and Professions Code §§5200 et seq.]

Locating signs off-site

Consider an agent who, on behalf of a seller of real estate, advertises the seller's property by placing a directional "For Sale" sign on a neighbor's property without first obtaining the neighbor's permission.

The neighbor discovers the "For Sale" sign on his property and removes it. However, the seller's agent continues to replace the sign on weekends without permission from the neighbor.

Does the neighbor have recourse against the broker?

Yes! Placing a sign on private property without the **property owner's permission** is a misdemeanor public nuisance. Preventing a public nuisance is the responsibility of local government authorities on a complaint from the owner who does not consent to the placement of directional signs. [Calif. Penal Code §§556.1, 556.3]

Further, if a property owner or a real estate agent places a "For Sale" or a directional sign on public property without permission, such as on a sidewalk right-of-way or at the curbside, the placement is also a misdemeanor public nuisance. [Pen C §556]

Cities and counties often refuse or severely limit the granting of permission for placement of "For Sale" signs on public property, such as street corners, choosing to strictly enforce the penalties allowed by the California Penal Code. [Pen C §556]

When government agencies do allow "For Sale" signs, they are usually by a special permit and payment of use fees, and allowed only for the sale of parcels in a subdivider's development.

Mobilehomes

A mobilehome owner can place a "For Sale" sign:

- in the window of his mobilehome; or
- outside the mobilehome facing the street.

Signs posted outside of the mobilehome can be of an H-frame or A-frame design and must face the street, but cannot extend into the street. [CC §798.70]

Signs in mobilehome parks may be up to 24 inches wide and 36 inches high, and may contain the name, address and telephone number of the mobilehome owner or the owner's agent.

The right to display mobilehome "For Sale" signs extends to brokers, joint tenants, heirs or a representative of a mobilehome owner's estate who acquires ownership of a mobilehome on the owner's death.

Also, mobilehome owners and their agents can display an "open house" sign in the same locations as "For Sale" signs, if the mobilehome park does not prohibit open house signs.

Tubes or holders for leaflets with information on the mobilehome being advertised may be attached to either the "For Sale" sign or to the mobilehome. [CC §798.70]

Chapter 5 — The home inspection report

This chapter introduces the seller's and listing agent's use of a home inspection report to document the present physical condition of the listed property for prospective buyers.

Transparency by design

A seller of a one-to-four unit residential property, on entering into a listing to sell the property, is asked to give the listing agent authority to order out a home inspection report (HIR) from a local home inspection company as part of the seller's cost to market the property for sale.

The listing agent explains the HIR will be used to complete the seller's Condition of Property (Transfer) Disclosure Statement (TDS). The report will then be attached to the seller's TDS.

On receipt of the report, the seller could act to eliminate some or all of the deficiencies noted in the home inspection report. On the elimination of any defects, an updated report would be ordered out for use with the TDS.

The seller's TDS, as reviewed by the listing agent and supplemented with the HIR, will be used to inform prospective buyers about the **precise condition** of the property before they make an offer to purchase. Thus, the seller will not be confronted later with demands to correct defects or to adjust the sales price in order to close escrow. The property will have been purchased by the buyer "as disclosed."

The listing agent's marketing role

The task of gathering information about the condition of the property listed for sale and delivering the information to prospective buyers lies primarily with the listing agent. [Calif. Civil Code §2079]

Further, to retain control throughout the process of marketing, selling and transferring ownership, the listing agent should be the one who requests the HIR (on behalf of the seller). The agent will lose control over the marketing and closing process, and expose himself to claims of misrepresentation, when the buyer or the buyer's agent is the one who first orders the HIR.

As part of the listing agent's management of the home inspection activity, the agent should be present while the home inspector carries out his investigation of the property. The agent can discuss the home inspector's observations and whether his findings are **material** in that they affect the desirability, value, habitability or safety of the property, and thus its value to prospective buyers.

If the listing agent cannot be present, then he should request that the home inspector call the agent before the HIR is prepared to discuss the home inspector's findings and any recommendations he may have for further investigation. On receipt and review of the report by the seller and listing agent, any questions or clarifications they may have on its content should be followed up by a further discussion with the home inspector, and if necessary, an amended or new report.

Home inspector's qualifications

Any individual who holds himself out as being in the business of conducting a home inspection and preparing a home inspection report on his findings during the inspection of a one-to-four unit residential

property is a **home inspector**. No licensing scheme exists to set the minimum standard of competency or qualifications necessary to enter the home inspection profession. [Calif. Business and Professions Code §7195(d)]

However, general contractors, structural pest control operators, architects and registered engineers typically conduct home inspections and prepare reports as requested by sellers, buyers and their agents. The **duty of care** expected of licensed members of these professions by prospective buyers who receive and rely on their reports is set by their licensing requirements and professional attributes, i.e., the skill, prudence, diligence, education, experience and financial responsibility normally possessed and exercised by members of their profession. These licensees are experts with a high level of duty owed to those who receive their reports. [Bus & P C §7068]

Those home inspectors who **do not hold** any type of license relating to construction, such as a person who is a construction worker or building department employee, are required to conduct an inspection of a property with the same "degree of care" a reasonably prudent home inspector would exercise to locate material defects during their **physical examination** of the property and report their findings. Prospective buyers who rely on home inspection reports can expect a high level of competence from experts. [Bus & P C §7196]

However, a home inspector who is not a registered engineer cannot perform any analysis of systems, components or structural components which would constitute the practice of a civil, electrical or mechanical engineer. [Bus & P C §7196.1]

Hiring a home inspector

A seller's broker and listing agent can rely on **specific items** in a home inspection report (HIR) to prepare their final TDS. Their reliance on an HIR prepared by an inspector relieves the seller and the listing broker from liability for errors which are unknown to them to exist. However, to rely on the HIR, they must be free of simple negligence in the selection of the home inspector who inspects and prepares the HIR. Thus, the broker must exercise *ordinary care* when selecting the home inspector.

If **care in the selection** of a home inspector is lacking, then reliance on the HIR by the seller and listing agent preparing the TDS will not relieve the broker or the listing agent of liability.

However, use of an HIR by the listing agent does not relieve the agent (or his broker) from conducting their mandatory visual inspection. [CC §1102.4(a)]

Thus, the broker and listing agent must look into or be aware of whether the home inspector who prepares the report is qualified. The home inspector who holds a professional license or is registered with the state as a general contractor, architect, pest control operator or engineer is deemed to be qualified, unless the agent knows of information to the contrary.

When hiring a home inspector, the qualifications to look for include:

- educational training in home inspection related courses;
- length of time in the home inspection business or related property or building inspection employment;
- errors and omissions insurance covering professional liability;
- professional and client references; and

- membership in the California Real Estate Inspection Association, the American Society of Home Inspectors or other nationally recognized professional home inspector associations with standards of practice and codes of ethics.

Remember, the reason for hiring a home inspector in the first place is to assist the seller and his listing agent to better represent the condition of the property to prospective buyers, and hopefully reduce the risk of errors.

Reliance by buyers on the report

A listing agent requesting a home inspection report should advise the home inspector that the seller, broker and all prospective buyers of the property will be relying on the report. This disclosure will avoid later (unenforceable) claims by the home inspector that the report was intended for the sole use of the seller, broker or buyer who signed the home inspector's contract. [CC §1102.4(c)]

Consider a buyer under a purchase agreement who requests a home inspection report on the property being purchased. On receipt of the report, the buyer cancels the purchase agreement. Another prospective buyer receives the same home inspection report from the listing agent and relies on it to acquire the property.

However, the report fails to correctly state the extent of the defects. The second buyer discovers the errors and makes a demand on the home inspector who prepared the report for the first buyer to cover the cost to cure the defects which were the subject of the errors.

The home inspector claims the report was prepared only for use by the buyer who requested the report and no subsequent buyer can now rely on it, as stated in the home inspection contract.

Here, the home inspector knew the listing agent also received the report and should have known that the agent would properly provide it to other prospective buyers if the buyer who ordered the report did not complete the purchase. A home inspection report, like an appraisal-of-value report or a structural pest control report, is not a confidential document. Thus, all prospective buyers of the property are **entitled to rely** on the existing home inspection report.

This reliance by other prospective buyers imposes liability on the home inspector for his failure to exercise the level of care expected of a home inspector when examining the property and reporting defects. Liability for the defects is imposed even though the home inspection contract and report contained a provision restricting its use solely to the person who requested it. [**Leko** v. **Cornerstone Building Inspection Service** (2001) 86 CA4th 1109]

The home inspection contract

Provisions in a contract with a home inspector and his home inspection company which purport to limit the dollar amount of their liability for errors, inaccuracies or omissions in their reporting of defects to the dollar amount of the fee they received for the report are unenforceable.

Further, any provision in the home inspection contract or condition in the home inspection report which purports to waive or limit the home inspector's liability for the negligent investigation or preparation of the HIR is unenforceable. [Bus & P C §7198]

Should the buyer discover an error in the HIR regarding the existence or nonexistence of a defect affecting the value or desirability of the property, the buyer has no more than four years after the **date of the inspection** to file a legal action to recover any money losses. [Bus & P C §7199]

Occasionally, a boilerplate provision in the home inspector's contract or the home inspection report will attempt to limit the buyer's period for recovery to one year after the inspection occurred. However, any such limitation the home inspector places on time periods during which the buyer must discover and make a claim is unenforceable. The statutory four-year period is needed to provide time for buyers to realize the home inspector produced a faulty report. [**Moreno** v. **Sanchez** (2003) 106 CA4th 1415]

The home inspector's malpractice insurance

An agent ordering a home inspection report needs to verify the home inspection company has **professional liability insurance coverage** before allowing the company to conduct an investigation and prepare a report.

Should the home inspector fail to detect and report a material defect or the extent of the defect, and the cost to correct it is significant, the buyer will be seriously disadvantaged in any recovery effort against the home inspector and the home inspection company unless insurance is available to pay amounts recoverable by the buyer.

Likewise, if the same defect was also missed by the listing agent due to the agent's failure to observe the defect during the agent's mandatory visual inspection, the broker and the listing agent are also liable to the buyer for the costs of curing the defect — separate from the home inspector's liability.

Here, the broker and listing agent will be able to force the home inspector to contribute to the recovery by an *indemnification claim* made by the broker against the home inspector for payment of all or a portion of the buyer's loss. Unless the home inspector has insurance coverage, the ability of the seller's broker to force the home inspection company to pay the home inspector's share of the responsibility for having failed to observe the same defect the listing agent missed will be limited to the home inspector's personal assets. [Leko, *supra*]

The inspection and report

A home inspection is a **physical examination** conducted on-site by a home inspector. The inspection of a one-to-four unit residential property is performed for a noncontingent fee.

The purpose of the physical examination of the premises is to identify *material defects* in the condition of the structure and its systems and components.

Material defects are conditions which affect the property's:

- market value;
- desirability as a dwelling;
- habitability from the elements; and
- safety from injury in its use as a dwelling.

Defects are material if they adversely affect the **price** a reasonably prudent and informed buyer would pay for the property when entering into a purchase agreement. As the report may affect value, the investigation and delivery of the home inspection report to a prospective buyer must precede a prospective buyer's offer to purchase to be meaningful. [Bus & P C §7195(b)]

The **home inspection** is to be a *non-invasive examination* of the mechanical, electrical and plumbing systems of the dwelling, as well as the components of the structure, such as the roof, ceiling, walls, floors and foundations. Non-invasive indicates there will not be an intrusion into the roof, walls, foundation or

soil by dismantling or taking apart the structure which would disturb components or cause repairs to be made to remove the effects of the intrusion. [Bus & P C §7195(a)(1)]

The **home inspection report** is the written report prepared by the home inspector which sets forth his findings while conducting his physical examination of the property. The report identifies each system and component of the structure inspected, describes any material defects the home inspector found or suspects, makes recommendations about the conditions observed and suggests any further evaluation needed to be undertaken by other experts. [Bus & P C §7195(c)]

The listing agent needs to make sure the report addresses the cause of any defect or code violation found which constitutes a significant defect in the use of the property or cost to remedy the defects. The report should also include suspicions the home inspector might have which need to be clarified by further inspections and reports by others with more expertise.

The agent, or anyone else, may also request that the home inspector conduct an inspection on the energy efficiencies of the property and include his findings in the report. On a request for an **energy efficiency inspection**, the home inspector will report on items including:

- the R-value of the insulation in the attic, roof, walls, floors and ducts;
- the quantity of glass panes and the types of frames;
- the heating and cooling equipment and fans;
- water heating systems;
- the age of major appliances and the fuel used;
- thermostats;
- energy leakage areas throughout the structure; and
- the solar control efficiency of the windows. [Bus & P C §7195(a)(2)]

The home inspector's conflicts of interest

The home inspector who prepares a home inspection report, the company employing the home inspector and any affiliated company may not:

- pay a referral fee or provide for any type of compensation to brokers, agents, owners or buyers for the referral of any home inspection business;
- agree to accept a contingency fee arrangement for the inspection of the report, such as a fee payable based on the home inspector's findings and conclusions in the report or on the close of a sales escrow;
- perform or offer to perform any repairs on a property which was the subject of a HIR prepared by them within the past 12 months; or
- inspect any property in which they have a financial interest in its sale. [Bus & P C §7197]

Chapter 6 The listing agent and the prospective buyer

This chapter focuses on a listing agent's limited, nonfiduciary general duty owed to all prospective buyers as distinguished from a buyer's agent's special fiduciary agency duties owed to these buyers.

General duty to voluntarily disclose

A listing broker and his agents have a special *fiduciary agency duty*, owed solely to a seller who has employed the broker, to diligently market the listed property for sale. The objective of this employment is to locate a prospective buyer who is ready, willing and able to acquire the property.

On locating a prospective buyer, either directly or through a buyer's agent, the listing agent owes the prospective buyer, and thus also the buyer's agent, a limited, nonclient *general duty* to **voluntarily provide** information on the listed property, called *disclosures*. What is limited about the duty is not the extent or detail to which the listing agent may go to provide information, but the **minimal quantity of fundamental information** and data about the listed property which must be handed to the prospective buyer or the buyer's agent.

The information disclosed need only be sufficient enough in its nature to place the buyer on notice of facts which may have an adverse affect on the property's value.

Thus, the disclosure obligations of the listing agent to voluntarily inform prospective buyers about the fundamentals of the listed property acts to limit the listing agent's ability to employ any conduct or means at hand to exploit the prospective buyer. The listing agent may not:

- deliver up less than the minimum level of information to put the buyer on notice of the property's fundamentals;
- give unfounded opinions or deceptive responses in response to inquiries; or
- stifle inquires about the property while in the vigorous pursuit of the best financial advantage obtainable for the seller.

Gathering facts on adverse features

The gist of a listing agent's limited general duty owed to a nonclient prospective buyer is to put the prospective buyer or the buyer's agent on notice of facts which might, if known to the prospect, **adversely affect his valuation** of the listed property.

The **methods for gathering** adverse facts about the property's fundamental characteristics, as well as those facts which enhance value, which the listing agent is specifically required to use on a **one-to-four unit residential property** include:

- conducting a **visual inspection** of the property to observe conditions which might adversely affect the market value of the property and entering any observations on the seller's Condition of Property (Transfer) Disclosure Statement (TDS) if not already noted on the TDS by the seller or if inconsistent with the seller's disclosures, regardless of whether a home inspector's report has been or will be obtained by the seller [Calif. Civil Code §2079];

- assuring compliance by the seller with the **seller's duty** to deliver statements to prospective buyers as soon as practicable, i.e., disclosing a variety of facts about natural hazards (NHD), the condition of the property (TDS), the local environment (TDS), Mello-Roos liens, lead-based paint, neighborhood industrial zoning, occupancy and retrofit ordinances, military ordnance locations, condo documents, etc., **by providing the seller** with statutory forms at the listing stage to be filled out by the seller, and picking up the seller prepared and signed documents for inclusion in the marketing/listing package to be handed to prospective buyers;
- **reviewing and confirming**, without further investigation or verification by the listing agent, that all the information and data in the disclosure documents received from the seller are consistent with the listing agent's knowledge about the information and data, and if not, correct the information and data, or if the listing agent has reason to believe the information might not be accurate, either investigate and clarify the information or disclose his uncertainty about the information to the seller and the prospective buyer;
- advising the seller on **risk avoidance procedures** by recommending the seller obtain third-party inspections of the property's condition and its components (roof, plumbing, septic, water, etc.), to **reduce the exposure** to claims by a buyer who might discover deficiencies in the property not known to the seller or the listing agent or were known and not disclosed prior to entry into a purchase agreement, and then make a demand on the seller (and the broker) to correct the defects or reimburse the buyer for the costs incurred to correct them; and
- **responding to inquiries** by the prospective buyer or buyer's agent into conditions relating to any aspect of the property with a full and fair answer of related facts known to be or which might be considered detrimental to the value of the property without suppressing further investigation or inquiry by the buyer or the buyer's agent since the inquiry itself makes the subject matter a *material fact* about which the prospective buyer needs more information before completing negotiations or acquiring the property.

The pass-through of filtered information

A listing agent's statutory duty owed to prospective buyers to disclose facts about the integrity of the physical condition of a listed one-to-four unit residential property is limited to his prior knowledge about the property and the observations he made while conducting his **mandatory visual inspection**. To complete the disclosure process, the listing agent serves as a conduit through which property information provided by the seller is filtered before it is passed on to the prospective buyer.

Accordingly, all property information received from the seller must be reviewed by the listing agent for any inaccuracies or untruthful statements **known or suspected to exist** by the listing agent. Corrections or contrary statements by the listing agent must be included before the information may be used to market the property and induce prospective buyers to purchase.

Unless asked on an inquiry by a prospective buyer or buyer's agent, the listing agent need only comply with minimal disclosure requirements.

The extent to which disclosures about the physical condition of the property must be made is best demonstrated by what the listing agent is **not obligated** to provide.

Of concern to buyer's agents is the fact listing agents have **no duty to investigate** any of the information or data provided by the seller in an effort to authenticate its accuracy or truthfulness before passing it on to the prospective buyer.

However, before handing a prospective buyer information received from the seller, the listing agent must:

- **review the information** received from the seller;
- **include comments** about the agent's actual knowledge and observations he made during his visual inspection of the property which reflect the inaccuracies, inconsistencies, false nature or omissions in the seller's statements; and
- **identify the source** of the information as the seller.

The dumb agent rule

A listing agent on a one-to-four unit residential property **owes no affirmative duty** to a prospective buyer to gather or voluntarily provide the prospect with any facts about:

- the property's **title conditions**, consisting of encumbrances which a preliminary title report would disclose, such as easements, Covenants, Conditions and Restrictions (CC&Rs), legal descriptions, trust deed provisions, etc., other than assuring compliance by the seller with disclosures about liens for improvement district bonds, such as Mello-Roos bonds;
- the **operating expenses** for the property (and any tenant income) the buyer will experience during ownership, such as utilities, sanitation, property taxes, yard and pool maintenance, insurance, etc., except the statutory disclosures the seller must make about any fire hazard clearance requirements which exist due to the property's location (NHD);
- the **zoning** or other **use restrictions** which may affect the buyer's future use of the property, except for the existence of industrial zoning, which affects the property, and nearby ordnance locations;
- the **income tax aspects** of the buyer's acquisition (or seller's disposition) of the property, such as limitations on interest deductions, avoidance of profit tax by exclusion or exemption on the sale of other property (on which the purchase of the listed property may be contingent);
- the **suitability of the property** to meet the buyer's objectives in the acquisition, be they financial, legal, possessory, etc.; and
- information or data on any **mixed use** of the property, such as acreage included in the purchase for use as subdividable lands, groves or other farming operations, or for use for tenant income or as a vacation rental.

Further, the listing agent owes no duty to prospective buyers to give advice, make recommendations, offer suggestions, comment on the extent of the adversity of the (adverse) facts disclosed, offer assistance (locate boundaries), investigate (due diligence), state an opinion or explain the effect on the buyer of any facts about the property's physical, natural or environmental conditions which have been provided by the listing agent.

However, **when asked** by the prospective buyer or a buyer's agent about any aspect, feature or condition which relates to the property or the transaction in some way, the listing agent is duty-bound to respond fully and fairly to the inquiry. The response must include material facts known to the listing agent about the subject matter of the inquiry and be free of half-truths and misleading statements.

Conversely, it is the buyer or the buyer's agent on his behalf who has a **duty to care for and protect** the buyer's best interests in the purchase of property. The buyer's agent, not the listing agent, must determine what due diligence efforts are first required before allowing the buyer to make the decision to purchase or close escrow.

Opinions in lieu of investigations

Consider a listing agent of a residence who is asked by a prospective buyer to point out the location of the boundaries for the lot on which the home is located. The listing agent does not provide the buyer with the metes and bounds description contained in subdivision maps or tell the buyer to investigate the location of the boundaries himself. Instead, the listing agent says the boundaries are represented by a fence which surrounds the property.

The listing agent does not indicate the source of this opinion, such as the seller, a surveyor or himself. He also does not conditionalize his statement with words such as "the boundaries in this subdivision are usually where the fence has been placed." The listing agent did not even say, "in my opinion" or "I believe" to state any uncertainty he may have about the location of the boundaries. His statement of the boundary location was absolute — it is the fence.

The buyer further indicates he intends to have a pool built for the use of his family if he acquires the property. The listing agent does not respond to the buyer's statement about the intent to build a pool. The listing agent has no actual knowledge of easements or zoning ordinances which could **adversely affect** implementation of the buyer's intended future use of the property.

Further, the buyer asks the seller to confirm whether the fences are the outside parameters of the property. The seller indicates the fences demarcate the division line between the properties.

Without further investigation, a purchase agreement is entered into by both the prospective buyer and the seller. In preparation of the purchase agreement offer, the listing agent does not include a contingency provision to provide the buyer with an opportunity to verify the location of the boundaries or to confirm his ability to obtain a permit to build a pool as a condition for closing escrow.

Prior to closing, the title company is not asked nor is a surveyor brought in to establish the boundaries. Neither the local planning department nor a pool contractor was consulted about the ability to obtain a permit to build a pool.

The actual facts place the location of the rear fence several feet beyond the property line, giving the rear yard the actual appearance of having sufficient room to accommodate a pool, which it will not. Also, an easement for water lines and a sewer line runs across the entire rear of the property, as well as along one side of the home allowing these services to be supplied to a rear, uphill property.

Here, the buyer acted in reliance on the listing agent's (and seller's) opinion about the location of the boundaries to close escrow. As a result, liability for the boundary discrepancy will be imposed on the listing agent for his failure to **conditionalize his statement** about the location of the boundaries. Without qualifying his statement, it was a misrepresentation about the actual location of the boundaries.

Further, the listing agent, due to his lack of actual knowledge of the easements, has no liability exposure for his failure to disclose the easements which further interfered with meeting the announced interest of the buyer to build a pool. The listing agent did not owe the buyer a duty to advise him of the need to check title for any easements or restrictions which might interfere with the construction of a pool.

The listing agent did conduct a visual inspection of the property and observed nothing which indicated the existence of an easement. Further, he knew nothing about any such easement and, importantly, had no duty to investigate the condition of title or zoning since they are public records and go beyond observations resulting from a visual inspection.

Since the buyer made an inquiry (boundaries) and announced an intended use of the property (build), the information about the subject matter of the inquiries and the announced use became *material facts*. When a listing agent responds, as he must, to an inquiry by a prospective buyer and gives information without conditionalizing his statement, **the buyer may rely** on the information and proceed to acquire the property without further confirmation of the accuracy or truthfulness of the information.

Here, due to the inquiry, the listing agent should have included a **contingency provision** in the purchase agreement. Then, the buyer would have been required as a condition of closing to further investigate. Thus, if the results of the due diligence investigation into the feasibility of constructing a pool (and the location of the boundaries) were not satisfactory to the buyer, he could have cancelled the transaction.

Without the inquiry from the buyer, the listing agent would not have volunteered his opinion about the location of the boundaries. Thus, without the inquiry he would not have gone beyond his minimum required disclosures about the physical condition of the property. Once he did respond to the request of the buyer, a contingency provision for further approval of the condition included in the purchase agreement would have avoided the dispute (and possibly the sale).

In response to an inquiry

A listing agent owes no duty to a prospective buyer to address the existence, much less the nature, of an easement located on the listed property. However, when the listing agent responds to an inquiry by the prospective buyer by providing information on the easement, he must state fully and fairly, without deceptive or misleading wording, his knowledge about the easement. Further, he must **identify the source** of his information if he has not confirmed its accuracy or correctness, or **condition his response** in such a way as to prevent the prospective buyer from justifying any reliance on the information without further investigation.

Consider a prospective buyer who has no experience in real estate matters. The prospective buyer deals directly with the listing agent of a property which seems suitable to the buyer. The prospective buyer observes a 30-foot easement on the subdivision map running the entire width of the frontage to the property. He asks the listing agent what the easement is about. The listing agent responds, explaining it is “for those water lines you find on the curb of the street, it is nothing to worry about.”

The prospective buyer decides to buy the property and build a home on it. In escrow, the preliminary title report also reflects the easement. On further inquiry by the buyer, the listing agent again assures the buyer it is on the front side of the lot and is not a problem due to the large setbacks.

After close of escrow and commencement of construction of a residence, the local water company digs a ditch 16 feet deep and installs a major waterline. The interference of the easement causes the buyer to relocate his driveway to the side street entrance since placing the driveway over the easement would require the buyer to remove it at his expense should the water company again need to access the easement in the future.

The buyer makes a demand on the listing agent for lost value paid for the property. The buyer had relied on the listing agent’s representation that the easement presented no problem to his use of the property, when in fact it did.

Here, the listing agent, having responded to an inquiry from the prospective buyer on the nature of the easement, must be candid in his explanation. The buyer must be informed about the significance of the buyer’s limited ability to use the portion of the lot burdened by the encumbrance of the easement. In-

stead, the listing agent gave evasive answers calculated to stifle and avoid the buyer's further investigation into the true facts about the burden placed on the property by the easement.

Since a material fact is involved, the buyer's inquiry is entitled to a response based on the listing agent's working knowledge of the underlying facts or by identifying the source of the information given. If the listing agent lacks sufficient knowledge to comment, he is duty-bound to say so.

Ads based on seller information

A listing agent may use information obtained from a seller concerning the size of a property in an **advertisement** offering property for sale, such as stating a parcel contains more than one acre or a home contains 5,000 square feet. The listing agent does not need to investigate whether this information is accurate as long as it is not known to the agent to be false. Further, the agent does not need to identify the seller as the source in his advertisement.

As for the advertisement used to locate buyers, the figure given must be consistent with the **observations** made by the listing agent while conducting his visual inspection of the property, e.g., does the property look like it contains more than one acre or look like a 5,000 square foot improvement? However, the listing agent is not required to measure the property or check the public records.

Conversely, in **response to an inquiry** from a prospective buyer expressing an interest or concern about the size of a parcel or improvement, the listing agent must either confirm the accuracy of the area or size, or attribute the information to a source.

For income-producing property, the operating income and expense data received from the seller can be passed on to the buyer or the buyer's agent by the listing agent by providing the buyer with the figures without either confirming its accuracy or disclaiming any responsibility for its correctness. However, no matter how presented to the prospective buyer, the listing agent is the conduit for information received from the seller. The listing agent must first **review it** and, if he has no knowledge the data might be suspect, inaccurate or a misrepresentation, provide it to the prospective buyer.

By giving the source of the information, the listing agent demonstrates the information **does not constitute the opinion** of the listing agent.

Sufficient notice to alert the buyer

Consider a listing agent of a condominium unit who is aware other units in the project have suffered water intrusion damage. Also, he is aware the homeowners' association (HOA) has filed a lawsuit against the developer to recover the cost of repair for the water intrusion damage in the affected units.

The agent conducts his statutorily mandated visual inspection of the unit, but finds no visible signs of water damage in the unit. The seller claims none exist.

A prospective buyer is located who is not represented by a broker. The seller's Condition of Property (TDS) disclosure on the property's physical condition, which includes the listing agent's observations, is handed to the buyer.

The TDS discloses the seller and the listing agent know of no water intrusion damage in the seller's unit. Further, the listing agent advises the prospective buyer about the existence of HOA litigation over water intrusion damage in other units within the project. The buyer does not further inquire or comment on the HOA litigation or water damages to the project.

The buyer then makes an offer to purchase the property as prepared by the listing agent. The offer contains wording acknowledging the buyer's awareness of the HOA's water intrusion lawsuit and receipt of the TDS, as well as other mandated disclosures.

Later, the listing agent receives newsletters and minutes from the HOA's meetings which further discuss the previously disclosed water intrusion problems. The listing agent also reads the HOA's complaint against the developer. The documents contain no new information and are not brought to the attention of the buyer.

Escrow closes and the buyer moves into the unit. Later, the buyer discovers pre-existing water intrusion damage to the unit.

The buyer claims the listing agent owed him a **general duty** to pass on all documents known to exist concerning the **extent** of the water intrusion damage in the development, such as the newsletters, minutes from the HOA meetings and a copy of the lawsuit filed by the HOA.

Did the seller's listing agent sufficiently inform the buyer about the water intrusion problem to **place the buyer on notice** that a water intrusion problem existed?

Yes! The listing agent disclosed the essential facts necessary to notify the buyer about the water intrusion damage. Once informed of the potential problem within the project, it was the buyer's duty (or the buyer's agent's duty) to exercise reasonable care to protect the buyer.

With notice of the problem, any further details concerning the extent or nature of the water intrusion were **readily ascertainable** by the buyer on request of the listing agent, the HOA or a third-party investigator. It was not the duty of the listing agent to also advise the prospective buyer to investigate the consequences of the facts disclosed before deciding to buy. [**Pagano** v. **Krohn** (1997) 60 CA4th 1]

Minimum level of disclosure

A listing agent locating a prospective buyer for his client's one-to-four unit residential property owes a duty to the prospective buyer to conduct a reasonably diligent **visual inspection** of the property for defects which adversely affect the value of the listed property. On completing the inspection, the listing agent must note on the (seller's) TDS any defects **observable or known** to the listing agent which are not already noted by the seller or are inconsistent with the seller's disclosures. The TDS is to be handed to prospective buyers *as soon as practicable*. [CC §§2079 et seq.]

However, the visual inspection and investigation of one-to-four unit residential property by the listing agent and the disclosure of his knowledge and observations excludes other readily available information, such as:

- the inspection of areas reasonably and normally **inaccessible** to the broker;
- the investigation of **off-site areas** and areas surrounding the property; and
- the inquiry into or review of **public records** or permits concerning title or use of the property. [CC §2079.3]

However, the minimum disclosure rule does not apply to a buyer's broker or his agents, much less limit the buyer's agent's duty to fully and fairly inform and advise on what investigation the buyer should undertake.

Further, the minimum one-to-four unit inspection and reporting requirements imposed on listing agents excludes the **common law duty** still imposed on listing agents of other types of property to further investigate and disclose to buyers or sellers any material facts he discovers regarding:

- title conditions;
- the financial consequences of owning the property, such as the property's operating costs; or
- the tax aspects of the transaction (seller only).

Purpose of inspection

The one-to-four unit disclosure limitation on listing agents serves to set a minimum level of information and data to be disclosed to put the buyer and the buyer's agent on **notice of physical defects** in the property which are **observable or known** to the seller or the listing broker and his agents.

For example, an agent lists a residence located on a hillside. The property is subject to natural geological hazards including a high groundwater level, landslides and a fault line.

A prospective buyer for the property is located by the listing agent. The buyer is informed a neighboring owner has had problems with underground water on his property and that he installed a pump to manage the high water level. The listing agent also tells the buyer the neighbor's property previously suffered landslide damages.

The listing agent provides the buyer with a geological report the seller had acquired regarding the property. The report indicates the property lies within a geological hazard area and is susceptible to landslides and groundwater buildup.

The buyer is also informed a back fence was removed since erosion caused it to slide down the hillside. When asked by the buyer, the seller also discloses the pool is located in the front yard since a fault line runs through the backyard.

After a review of the disclosures, the buyer makes an offer to purchase the property.

The listing agent prudently includes a **further-approval contingency provision** in the purchase agreement. The contingency provision calls for the buyer to further investigate the hazards by obtaining his own geological report and approving it as a condition of closing.

Before closing, the buyer obtains a report which states the property shows signs of instability and confirms that a high groundwater level exists. The report also states the house does not show signs of cracking or distress.

During the escrow period, the listing agent attends a meeting between area homeowners and county officials in which the geological hazards of the properties in the area and possible solutions are discussed.

The listing agent does not inform the buyer of the occurrence of the meeting or the topics discussed since no information previously unknown to the agent and disclosed to the buyer was released.

Later, after escrow closes, the residence slides down the hillside and is condemned by the county as uninhabitable.

On a complaint filed by the buyer, the Department of Real Estate (DRE) attempts to revoke the listing agent's license claiming the subject matter of the meeting held by county officials was itself a fact which should have been disclosed to the buyer by the listing agent since the mere occurrence of the town hall meeting might have affected the buyer's decision to buy.

However, the listing agent was the **exclusive representative of the seller** of one-to-four residential units and only had a general nonfiduciary duty of disclosure to the buyer, which is limited to:

- providing the buyer with all existing geological reports held by the seller or the agent; and
- disclosing groundwater and landslide problems known to the listing agent which occurred on the property or in the neighboring area.

Here, the listing agent properly disclosed the geological hazards of the property by alerting the buyer to the potential problems. The homeowners' meeting was not required to be brought to the buyer's attention since the meeting was a review of the same geological hazards already known to the agent and disclosed to the buyer. Also, the buyer's independent investigation under the further-approval contingencies did not deter the buyer from proceeding with the purchase of the residence.

Thus, the listing agent did not violate the limited general nonfiduciary duty he owed to the nonclient buyer to disclose sufficient information on adverse property conditions to put a prospective buyer on notice so he (or the buyer's agent) could take steps to protect and care for the buyer's best interests. Thus, the DRE cannot revoke the listing agent's license for limiting his disclosures to the initial notice of the defect in the property without further elaboration. [**Vaill** v. **Edmonds** (1991) 4 CA4th 247]

Chapter 7 — Condition of property disclosure exemptions

This chapter discusses real estate transactions which are exempt from the statutory condition of property disclosures, but subject to common-law disclosures.

The common-law duty to disclose remains

A lender secured by a one-to-four unit residential property acquires the property by a deed-in-lieu of foreclosure.

The lender contacts a broker to list the property for sale. The broker inspects the property and observes soil defects which could adversely affect the value of the property.

The broker prepares a statutory condition of property statement disclosure form, noting the soil and other defects he observed.

The lender objects to the broker making any disclosures to prospective buyers on a condition of property statement form — or disclosing the known defects in any other manner.

The lender claims the resale transaction is exempt from any disclosures to the buyer.

The broker agrees the lender need not deliver the statutory condition of property statement to a buyer, but insists neither the lender nor the broker are exempt from their respective common-law duty owed to buyers to disclose property conditions which have a significant impact on the property's value.

Must the lender and the broker independently disclose the property conditions even though the resale of property acquired under a deed-in-lieu is exempt from using the statutory disclosure form?

Yes! The disclosure exemptions only apply to **delivery** of the statutory condition of property statement form, misleadingly called a *property transfer disclosure*. [Calif. Civil Code §1102.8]

Neither the lender nor the broker need fill out the statutory form. However, both must disclose property conditions known to them and unknown to the buyer.

The listing broker's general duty to a prospective buyer not only includes the disclosure of facts affecting the value or the desirability of the property, but requires all brokers to make a **reasonable inspection** of the property and disclose defects they discover which are significant in their impact on the value of the property, called material facts. [**Easton** v. **Strassburger** (1984) 152 CA3d 90]

The holding in *Easton* was partially codified, imposing a **statutory duty** on brokers to make a **reasonable inspection** of the property and use the statutory form to disclose their observation of any defects materially affecting the value of one-to-four unit residential real estate. [CC §2079]

Controlled transactions

Unless exempt, sellers and all brokers of one-to-four unit residential real estate are mandated to furnish buyers with a statutory condition of property statement. [CC §1102]

In the disclosure statement, the seller and the broker list any property defects known or suspected to exist. The sale of property will not be invalidated by the failure of the seller or the seller's broker to deliver the condition of property statement form before the close of escrow. However, the seller and the seller's broker will be liable to the buyer for the amount of actual damages caused by an undisclosed defect known to them — a point of law which has always existed. [CC §1102.13]

Transactions exempt from delivery of a condition of property statement, also called a *property transfer disclosure* include transfers:

- from co-owner to co-owner;
- from parent to child;
- from spouse to spouse, including property settlements resulting from a dissolution of marriage;
- by court order, such as probate, eminent domain or bankruptcy;
- by judicial or trustee's foreclosure sales;
- on resale of property acquired by a lender on a deed in lieu of foreclosure, or at their judicial foreclosure or trustee's sale;
- by tax sales;
- by reversion of unclaimed property to the state; and
- from or to any government agency. [CC §1102.2]

Also, property disclosures which a seller or broker must make to buyers are not limited to the items specified in the statutory disclosure form. Facts about the property's location, title conditions and operating data affect value, and are not referenced in the statutory disclosure form, which has its emphasis on the physical condition of the land and improvements. [CC §1102.8]

Common-law duty to disclose

However, an exemption from delivery of the condition of property statement to buyers does not in any way limit or eliminate the long-standing seller's or broker's *common-law duty* to disclose all *known defects*. Misrepresentation and deceit toward the buyer is to be avoided in any transaction — even if the transaction is exempt from using the statutory disclosure form.

The best property disclosure tool is the preparation and delivery of the statutory disclosure form to prospective buyers on every transaction — even though the transaction is exempt or concerns property other than one-to-four residential units.

Deceit by silence

Consider a trust deed lender who holds a trustee's foreclosure sale on a one-to-four unit residential property. The lender knows soil defects exist on the property, but does not disclose the defects to the bidders at the trustee's sale — a sale exempt from use of the statutory disclosure form.

The high bidder at the trustee's sale later discovers the property's soil defects. The high bidder demands a full return of the sale price from the lender in exchange for his return of the property to the lender, a remedy called *rescission and restoration*.

The high bidder claims the lender had a common-law duty to bidders to disclose property defects known to the foreclosing lender which materially affect the value of the property.

The lender claims the exemption of trustee's sales transactions from use of the statutory form **eliminates any duty** the lender or trustee may have had to make any property condition disclosures. The lender

claims the ancient doctrine of *caveat emptor* (buyer beware) controls the bidding at the foreclosure sale — rules which put the buyers on notice they must investigate the property to discover any defects.

Can the high bidder rescind the sale for the lender's failure to disclose known defects in the condition of property?

Yes! A transaction's exemption from preparation and delivery of a statutory condition of property statement does not eliminate the lender's common-law duty as a seller to disclose known property defects to brokers and buyers. [**Karoutas** v. **HomeFed Bank** (1991) 232 CA3d 767]

Selling "as-is" isn't the violation

Since *Karoutas*, legislation states the lender (or the trustee) at a trustee's sale is not in violation of law if bidders are advised the property is being sold "as-is." [CC §2924h(g)]

By announcing the property is being sold "as-is," the lender makes no warranty or representation as to the condition of property.

Editor's note — However, even with legislation allowing lenders to sell property "as-is" at trustees sales, Karoutas *represents a line of reasoning the courts will likely uphold. Courts will not allow a foreclosing lender to be protected from liability for intentional misrepresentation and deceit at a public sale if the buyer later discovers a defect the lender knew existed and failed to disclose. The disclaimer stating the property is sold "as-is" draws the lender into the web of deceit by silence, called intentional misrepresentation by omission.*

Announcing the property is sold "as-is" does not excuse the lender from his common-law duty to disclose defects which affect the condition of the property. While the lender does not have the brokerage duty to investigate and disclose the condition of the property, the lender has a common-law duty to disclose known facts concerning the condition of the property — until the legislature states its intention to eliminate the lender's common-law disclosure duty expressed in Karoutas *by codifying the reestablishment of the ancient doctrine of caveat emptor.*

Chapter 8 Safety standards for improvements

This chapter discusses the need for the seller and listing agent to make disclosures about the property's noncompliance with current safety standards before acceptance of a buyer's offer.

Disclosing noncompliant improvements

A seller of a one-to-four unit residential property, who is solicited by a listing agent, enters into a listing agreement employing the agent's broker to locate buyers and sell the property.

The seller is asked to fill out a Transfer Disclosure Statement (TDS) and return it to the listing agent. When the TDS is filled out by the seller and picked up by the listing agent, the agent will conduct his own **visual inspection** of the property as mandated. On completion of the inspection, the agent will note any defects he observed on the TDS and sign it. [Calif. Civil Code §2079; see **first tuesday** Form 304]

The seller fills out and signs the TDS and returns it to the listing agent.

The listing agent then conducts his visual inspection of the property to identify components and defects not disclosed by the seller on the TDS. He **observes several safety conditions** which he knows do not meet current building codes. These observations are noted on the seller's TDS in the space provided above the location for the listing agent's signature.

The disclosure statement signed by the seller and listing agent now reveals that the garage door closing mechanism is not equipped with an automatic reversing device, the spa does not have a locking safety cover, the pool does not have barriers restricting access, the water heater is not anchored or braced, and the security bars on the windows in one of the bedrooms do not have a release mechanism — all in violation of current safety standards.

The TDS and all other seller disclosures and property reports are included as part of a listing package the listing agent will hand to prospective buyers and buyer's agents.

At an open house held on the property by the listing agent, a visitor indicates he is interested in possibly buying the property and asks for more information about the property.

By the visitor's request for additional property information, the visitor has begun negotiations. Thus, he has become a *prospective buyer*, entitled to a complete set of disclosures from the seller or the seller's agent before any offer is made.

The listing agent responds to the request by handing the prospective buyer the listing package which includes a copy of the TDS for the buyer's review.

A purchase agreement offer is then prepared and eventually signed by the prospective buyer, acknowledging receipt of the TDS and all other disclosures mandated for the transaction. The purchase agreement offer does not contain a provision calling for the seller to correct any of the **previously disclosed safety defects** or to bring the property up to current building standards.

However, prior to closing, the buyer becomes concerned about the existing safety defects. Also, local ordinances may require the safety defects to be eliminated before issuing the buyer a certificate of occupancy.

The buyer makes a demand on the seller to repair, replace or install an automatic reversing device for the garage door, a locking cover for the spa, barriers to restrict access to the pool, a brace or anchor on the water heater and security bar release mechanisms as necessary to meet current safety standards. The buyer claims the seller must cure the safety defects by meeting current construction standards before the seller can require the buyer to close escrow on the sale.

The seller refuses to cure any of the defects, claiming the buyer must close escrow since the **buyer knew** the defects existed before entering into the purchase agreement and the seller never agreed to correct the defects and bring the property up to current building codes.

Can the seller cancel or enforce the purchase agreement when the buyer refuses to close escrow due to the existence of physical defects in the property known to the buyer before the buyer agreed to purchase the property, which the seller has not agreed to cure?

Yes! The buyer knew the precise condition of the property when he agreed to the price he would pay to purchase the property.

Thus, the buyer agreed to acquire the property "as disclosed" in the seller's TDS. The buyer was **on notice** of the defects prior to his agreement to buy the property and did not bargain for the seller to cure the defects as a condition for paying the agreed price.

Automatic garage doors

All automatic garage doors installed after January 1, 1991 are required to have an automatic reverse safety device which meets code. [Calif. Health and Safety Code §19890(a)]

In addition, garage door openers installed after January 1, 1993 are required to have a sensor which, when garage door movement is interrupted or misaligned, causes a closing door to open and prevents an open door from closing. [Health & S C §19890(b)]

The safety standards for garage doors are designed to prevent children from becoming trapped under closing doors. Property constructed before 1993 probably do not meet current safety standards.

Further, when any residential garage door is serviced, the person servicing the garage door must test whether the door reverses on contact with a two-inch high obstacle placed beneath the door.

If the door does not reverse, the repairman must place a warning sticker on the garage door stating the door does not reverse and is not in compliance with current safety standards. [Health & S C §19890(e)]

Child resistant pool barriers

A construction permit issued after 1997 for a pool at a single-family residence requires the completed pool to comply with **at least one** of the following safety requirements, i.e.,:

- the pool is isolated from access to the house by a surrounding fence or barrier at least 60 inches in height;
- an approved safety cover is installed for the pool;
- all the doors of the residence providing direct access to the pool are equipped with exit alarms;

- all the doors of the residence providing access to the pool are equipped with a self-closing, self-latching device with a release mechanism placed no lower than 54 inches above the floor; or
- some other means of protection as determined to be adequate by the building official in the area where the permit is issued is installed. [Health & S C §115922]

These safety requirements do not apply to hot tubs or spas with locking safety covers.

Condominium and apartment projects are not required to maintain safety barriers for pools and spas as their projects are not classified as single-family residences. Also, pools in condos and apartments are considered public facilities.

However, condo projects and apartment buildings must post signs indicating whether or not lifeguard services are available. Lifeguard services are not required, and if not provided, a sign saying so must be posted. [Health & S C §116045]

Public pools and spas are considered environmental hazards to a user's health if the managers do not operate and maintain them in a sanitary, healthful and safe manner. [Health & S C §116040]

If pools and spas in multiple-housing projects are not operated or maintained in a sanitary, healthful and safe condition, the pools and spas are considered a public nuisance and can be shut down by local health inspectors. [Health & S C §116060]

Water heaters

All existing residential water heaters are to be anchored, braced or strapped to prevent displacement due to an earthquake. [Health & S C §19211(a)]

A residential seller must state whether the water heater is anchored, braced or strapped. [Health & S C §19211(b)]

If the water heater meets safety requirements, the seller notes the compliance by marking the box on the TDS next to "anchored, braced or strapped." No further notice is necessary as it would be redundant and is not required.

If the seller's water heater does not comply, the seller should include a written statement on the TDS disclosing that fact.

When a prospective buyer receives the TDS before entering into a binding purchase agreement, and the TDS notes the water heater is not in compliance with safety standards, the prospective buyer has agreed to accept the property with the defect, unless a provision to the contrary is included in the purchase agreement.

Residential security bars

Security bars on residential property must have release mechanisms for fire safety reasons.

However, the release mechanisms are not required if each bedroom with security bars contains a window or door to the exterior which opens for escape purposes. [Health & S C §13113.9]

Chapter 9 Prior occupant's use, affliction and death

This chapter discusses the disclosure of a prior occupant's death or affliction with AIDS.

When and when not to disclose

A real estate broker and his listing agent are employed by a seller to locate a buyer for his real estate. The listing agent soon locates a buyer who wants to purchase the property.

Prior to making an offer, the listing agent hands the buyer the seller's Transfer Disclosure Statement (TDS) disclosing the seller's and agent's knowledge about the present **physical condition** of the property. All other mandatory disclosures are made.

The buyer does not inquire into any deaths which might have occurred on the property. Ultimately, the buyer acquires and occupies the property.

Later, a neighbor informs the buyer a prior occupant died on the property from AIDS or HIV. The prior occupant's death occurred **more than three years** before the buyer submitted the offer to purchase the real estate.

The buyer discovers the listing agent knew of the prior occupant's AIDS affliction and death on the property. The buyer claims the listing agent breached his agency duties since the agent had an affirmative duty to voluntarily disclose to the buyer that the prior occupant died on the property and was afflicted with AIDS.

Here, no real estate agent has an affirmative duty to **voluntarily disclose** information to a potential buyer regarding a prior occupant:

- whose death, from any cause, occurred on the real estate **more than three years prior** to the purchase offer; or
- who was afflicted with the HIV virus or afflicted with AIDS. [Calif. Civil Code §1710.2(a)]

*Editor's note — Deaths on the property which occurred **within three years** of the offer are treated differently.*

Disclosure on inquiry

Consider a buyer of real estate who asks the listing agent if any deaths have occurred on the property at any time.

On direct inquiry by the buyer or the buyer's agent, the listing agent must **disclose his knowledge** about whether deaths have occurred on the real estate, no matter when they occurred. [CC §1710.2(d)]

An intentional misrepresentation or concealment by any agent in the real estate transaction after a buyer makes a **direct inquiry** is:

- a breach of the listing agent's *general duty* owed to the buyer to truthfully respond when the listing agent represents the seller exclusively; or

- a breach of the buyer's agent's *agency duty* owed the buyer since the agent is the buyer representative in the transaction. [CC §1710.2(d)]

Further, an **inquiry** by the buyer into deaths is an indication a death on the premises is a fact which might affect the buyer's use and enjoyment of the property and constitute a *material fact*. Thus, an affirmative duty is imposed on the **buyer's agent** to either investigate or recommend an investigation by the buyer before an offer is made, unless the offer includes a contingency on the subject of death.

An agent who does not know whether a death occurred on the real estate and who, **on inquiry**, discloses he does not know or has limited information which he does disclose, should confirm the disclosure by handing the buyer a memorandum stating:

- the buyer has made an inquiry about deaths on the property;
- the agent has disclosed all his knowledge concerning the inquiry; and
- whether or not the agent will further investigate the occurrence of deaths on the property.

Deaths affecting market value

The duty of each agent in a transaction to disclose faces known to them which may adversely affect the property's value, called *material facts*, is not limited to disclosures of the property's physical condition.

Consider a buyer who enters into a purchase agreement negotiated by an agent, acting either as the buyer's agent or the listing agent. The offer includes the seller's TDS disclosures about the condition of the property as an attachment. However, the buyer is unaware multiple murders occurred on the property more than three years before the buyer's purchase offer.

The agent does not disclose the murders, **concealing his knowledge** of the murders from the buyer. The agent is aware that the notoriety of the murders **adversely affects** the market value of the property, placing its value below the price the buyer is agreeing to pay.

The transaction closes and the buyer occupies the property. The buyer learns of the multiple murders on the property. The buyer sues the agent to collect his price-to-value money losses, claiming the agent had a duty to disclose the deaths since the agent was aware the property's market value, due to the stigma of the deaths, was **measurably lower** than the purchase price paid by the buyer.

The agent claims he does not have a duty to disclose the deaths since the deaths occurred on the property more than three years ago and were not required to be disclosed on the TDS.

Did the agent have an affirmative duty to disclose the deaths?

Yes! The deaths had an **adverse affect** on the property's market value and were facts known to the agent. The deaths were a **material fact** and **intentionally concealed** from the buyer.

Thus, every agent has an affirmative duty owed to a buyer to disclose prior deaths when the death **might affect the buyer's valuation** or desire to own the property. [**Reed** v. **King** (1983) 145 CA3d 261]

Desirability based on prior events

Consider a buyer's agent who is aware a death, from any cause, occurred on the real estate **within three years** of a buyer's purchase offer. The value of the property is **not adversely affected** by the death. Thus, the knowledge is not a material fact about the property which needs to be disclosed.

The buyer does not ask his agent if any deaths have occurred on the property.

After closing, the buyer learns of the death.

The buyer is deprived of the pleasurable use and enjoyment he expected of the property — an **idiosyncrasy** of the buyer about death which was unknown to his agent.

The buyer claims the buyer's agent breached his special agency duty by failing to disclose the death since the death interferes with the buyer's intended use of the property by inflicting an intangible harm on the buyer which will not allow the buyer to occupy the real estate.

Here, the buyer's agent probably should have inquired of the buyer to determine if a known death on a property is a fact which might affect the buyer's decision to purchase the property. Since the buyer's agent has a greater agency duty to care for and protect the buyer than does a listing agent, a buyer's agent should disclose any death occurring on the property within three years, especially if he believes the death, no matter when it occurred, is a fact which might affect the buyer's decision to make a purchase agreement offer.

It is the buyer's agent's duty to **investigate and disclose** material facts about the property and the transaction, placing a greater burden on the buyer's agent to know and understand his client, a sort of **know-your-client rule**.

Conversely, the buyer has a duty of care, owed to himself, to **inquire and discover** facts to protect his own personal interests, especially uncommon ones.

However, whether or not a buyer's agent will be subject to any liability or penalties for not disclosing a death which occurred on the property within three years prior to the buyer's purchase offer when the agent was **unaware of the buyer's idiosyncrasy** and the death was not a material fact affecting the value of the property, has yet to be reported.

Chapter 10 Fire safety programs

This chapter discusses fire safety requirements for landlords, including smoke detectors, posting fire safety information and security bars.

Smoke detectors, security bars and safety information

A residential apartment building contains state- approved smoke detectors in each individual unit and in the common areas.

Later, a tenant informs the landlord the smoke detector in his unit does not operate even with new batteries.

The landlord and his manager do not repair or replace the broken smoke detector. Later, a fire breaks out in the tenant's unit during the night.

The tenant is unaware of the fire until he is injured and his property is damaged due to the defective smoke detector.

The tenant claims the landlord is liable for his losses since the landlord has a duty to repair or replace the defective smoke detector on notice from the tenant.

Is the landlord liable for property damage and personal injuries caused by the defective smoke detector?

Yes! On receiving notice that the smoke detector is inoperable, the landlord is required to promptly repair or replace it. [Calif. Health and Safety Code §13113.7(e)]

Further, a landlord will be subject to a $200 penalty for each failure to:

- install a smoke detector in each unit and in common areas as required; and
- repair or replace a faulty smoke detector on notice from the tenant. [Health & S C §13113.7(f)]

Tenant's duty to notify

Smoke detectors are required to be installed and maintained in all dwelling units intended for human occupancy, including single-family residences, duplexes, apartment complexes, hotels, motels, condominiums and time share projects. [Health & S C §§13113.7(b); 13113.8]

The smoke detector must be in operable condition at the time the tenant takes possession. [Health & S C §13113.7(e)]

If a smoke detector does not work when tested by the tenant, the **tenant is responsible** for notifying the landlord or property manager. The landlord is not obligated to investigate whether detectors are operable during the occupancy.

If the tenant does not notify the landlord about an inoperable smoke detector and the landlord is unaware of the condition, the landlord is not responsible for injuries caused by the faulty smoke detector. [Health & S C §13113.7(e)]

To repair or replace a faulty smoke detector, the landlord may enter the unit 24 hours after serving a written notice on the tenant of his intent to enter, unless the tenant gives permission for a prior entry. [Health & S C §13113.7(e); see **first tuesday** Form 567]

Duty to install and maintain

An ordinary battery-operated smoke detector installed according to the manufacturer's instructions satisfies the requirement for both single-and multiple-unit dwellings, unless another type is required by local ordinances. [Health & S C §13113.7(a)]

For example, some local ordinances require the smoke detector to receive its power from the building's electrical system.

To determine the smoke detector requirements for a property, the landlord can contact the **local fire department** or the county fire planning department.

In apartment units and other multiple-unit dwellings, such as condominiums, smoke detectors must also be installed in the common stairwells. The apartment landlord and his property manager are responsible for **installing and maintaining** smoke detectors in both the common stairwells and the individual units. [Health & S C §13113.7(c)]

Posting fire safety information

The landlord of an apartment building must provide emergency fire safety information to all tenants if the building consists of:

- two or more stories;
- three or more units; and
- a front door which opens into an interior hallway or lobby area. [Health & S C §13220(c)]

The information must be on signs using **international symbols**. The signs must be located:

- at every stairway and elevator landing;
- at the intermediate point of any hallway exceeding 100 feet in length and all hallway intersections; and
- immediately inside all public entrances. [Health & S C §13220(c)(1)]

Further, the landlord must provide fire information to all tenants through brochures, pamphlets or videotapes, if available, or conform to regulations adopted by the State Fire Marshal. [Health & S C §13220(c)(2)]

If the landlord negotiates the lease or rental agreement in a language other than English, the required information provided to the tenant must be in English, international symbols and the four most common foreign languages in California. [Health & S C §13220(c)(3)]

Editor's note — A consumer-oriented brochure in English, international symbols and the four most common foreign languages was to be available from the State Fire Marshal by July 1, 1996. [Health & S C §13220(d)]

However, this model brochure is still not available.

The State Fire Marshal has adopted California Code of Regulations Title 19 §3.09 concerning the dissemination of fire information to tenants in hotels, motels, office buildings and high-rises. Health and

Safety Code §13220 addresses these issues for tenants in apartment complexes. However, information does not exist as to which four languages will be used to translate the fire information.

If a landlord has any questions about the enforcement or the requirements for posting and informing tenants of fire information, he should contact his local fire department or the county fire planning department.

The codes and regulations are enforced on a local level, and each county or city may have different requirements for complying with the fire information regulations.

Emergency procedures for office buildings

Emergency procedures and information for office buildings of two or more stories must be provided to the building's occupants. [Health & S C §13220(a)]

The **emergency procedures information** for an office building of two or more stories may be published in the form of **literature**, pamphlets, etc., and must be available to all persons entering the building as well as located immediately inside all entrances to the building. [19 California Code of Regulations §3.09(a)(1)]

In lieu of literature, a **floor plan** providing emergency procedures must be posted at every stairway landing, elevator landing, and immediately inside all public entrances. [19 CCR §3.09(a)(2)]

For **high-rise structures**, fire safety requirements include:

- posting emergency procedures on a floor plan at every stairway landing, elevator landing, and immediately inside all public entrances; and
- appointing a Fire Safety Director to coordinate fire safety activities, train employees in the building, develop an emergency plan, etc. (which is also required of operators of hotels, motels and lodging houses). [19 CCR §§3.09(c), 3.09(d)]

A high-rise structure is a building rising more than 75 feet above the lowest floor level providing access to the building. [Health & S C §13210(b)]

Release mechanism in security bars

Security bars on residential property must have release mechanisms for fire safety reasons. The release mechanisms are not required if each bedroom with security bars contains a window or door to the exterior which opens for escape purposes. [Health & S C §13113.9]

Also, the owner of an apartment house must **install exit signs** that can be felt or seen near the floor of the exit. [Health & S C §17920.8]

Editor's note — Any questions concerning fire safety requirements or whether an owner has properly complied with the requirements should be directed to the local fire department or the county fire planning department. Some departments provide checklists of requirements which must be met.

Chapter 11 — Natural hazard disclosures by the listing agent

This chapter discusses the use of the Natural Hazard Disclosure (NHD) Statement by sellers and listing agents to fulfill their obligations to inform prospective buyers.

A unified disclosure for all sales

Natural hazards come with the **location** of a parcel of real estate, not with the man-made aspects of the property. Locations where a property might be subject to natural hazards include:

- special flood hazard areas, a federal designation;
- potential flooding and inundation areas;
- very high fire hazard severity zones;
- wildland fire areas;
- earthquake fault zones; and
- seismic hazard zones. [Calif. Civil Code §1103(c)]

The existence of a hazard due to the geographic location of a property affects its value and desirability to prospective buyers. Hazards, by their nature, limit a buyer's ability to develop the property, obtain insurance or receive disaster relief.

Whether a seller markets his property himself or lists the property with a broker, the seller must disclose to prospective buyers any natural hazards **known to the seller**, as well as those **contained in public records**.

To unify and streamline the disclosure by a seller (and his listing agent) about those natural hazards which affect a property, the California legislature created a statutory form entitled the *Natural Hazard Disclosure (NHD) Statement*.

The NHD form is used by a seller and his listing agent for their preparation (or acknowledgement of their review of a report prepared by an NHD expert) and disclosure of natural hazard information. The information is both known to the seller and listing agent (and the NHD expert) and available to them as shown on maps in the public records of the local planning department. [CC §1103.2; see Form 314 accompanying this chapter]

Actual use of the NHD Statement by sellers and their agents is **mandated** on the sale of **one-to-four unit residential properties**, called *targeted properties*. Some sellers of targeted properties are excluded from mandatory use of the form, but never their listing agents. Thus, the form, filled out and signed by the seller (unless excluded) and the listing agent, must be included in listing packages handed to prospective buyers on every one-to-four unit residential property.

Editor's note — Any attempt by a seller or listing agent to use an "as-is" provision or otherwise provide for the buyer to agree to waive his right to receive the seller's NHD statement is void as against public policy. [CC §1103(d)]

Regarding excluded sellers and sales of property other than one-to-four unit residential property, use of the statutory NHD Statement by sellers and listing agents is an **optional** method for making their disclosure of natural hazard information to buyers. However, delivery of the information by use of one

NATURAL HAZARD DISCLOSURE STATEMENT

DATE:_____________, 20______, at ____, California

Note: The seller's listing broker (and the seller) of one-to-four residential units shall prepare a NHD form and deliver it to prospective buyers prior to making a purchase agreement offer and indicate compliance in the purchase agreement or a counteroffer. If not so disclosed, the buyer has the right to cancel the purchase agreement within three days of delivery of the disclosure in person. [Calif. Civil Code §1103.3]

This disclosure statement is prepared for the following:

☐ Seller's listing agreement

☐ Purchase agreement

☐ Counteroffer

☐ ____

Dated:____________, 20______, at ____, California

Entered into by: ____

Regarding property referred to as: ____

____

Natural Hazard Disclosure Statement

Seller and Seller's Agent(s) or a third-party consultant disclose the following information with the knowledge that even though this is not a warranty, prospective buyers may rely on this information in deciding whether and on what terms to purchase the subject property.

Seller hereby authorizes any agent(s) representing any principal(s) in this action to provide a copy of this statement to any person or entity in connection with any actual or anticipated sale of the property

THE FOLLOWING ARE REPRESENTATIONS MADE BY SELLER AND SELLER'S AGENT(S) BASED ON THEIR KNOWLEDGE AND MAPS DRAWN BY THE STATE AND FEDERAL GOVERNMENT. THIS INFORMATION IS A DISCLOSURE AND IS NOT INTENDED TO BE PART OF ANY CONTRACT BETWEEN BUYER AND SELLER.

THIS REAL PROPERTY LIES WITHIN THE FOLLOWING HAZARDOUS AREA(S): (Check appropriate response)

1. A SPECIAL FLOOD HAZARD AREA (Any type Zone "A" or "V") designated by the Federal Emergency Management Agency.

Yes____ No____ Do not know/information not available from local jurisdiction____

2. AN AREA OF POTENTIAL FLOODING shown on an inundation map pursuant to Section 8589.5 of the Government Code.

Yes____ No____ Do not know/information not available from local jurisdiction____

3. A VERY HIGH FIRE HAZARD SEVERITY ZONE pursuant to Section 51178 or 51179 of the Government Code. The owner of this property is subject to the maintenance requirements of Section 51182 of the Government Code.

Yes____ No____

4. A WILDLAND AREA THAT MAY CONTAIN SUBSTANTIAL FOREST FIRE RISKS AND HAZARDS pursuant to Section 4125 of the Public Resources Code. The owner of this property is subject to the maintenance requirements of Section 4291 of the Public Resources Code. Additionally, it is not the state's responsibility to provide fire protection services to any building or structure located within the wildlands unless the Department of Forestry and Fire Protection has entered into a cooperative agreement with the local agency for those purposes pursuant to Section 4142 of the Public Resources Code.

Yes____ No____

5. AN EARTHQUAKE FAULT ZONE pursuant to Section 2622 of the Public Resources Code.

Yes____ No____

6. A SEISMIC HAZARD ZONE pursuant to Section 2696 of the Public Resources Code.

Yes (Landslide Zone)____ Yes (Liquefaction Zone)____
No____ Map not yet released by state____

THESE HAZARDS MAY LIMIT YOUR ABILITY TO DEVELOP THE REAL PROPERTY, TO OBTAIN INSURANCE OR TO RECEIVE ASSISTANCE AFTER A DISASTER.

THE MAPS ON WHICH THESE DISCLOSURES ARE BASED ESTIMATE WHERE NATURAL HAZARDS EXIST. THEY ARE NOT DEFINITIVE INDICATORS OF WHETHER OR NOT A PROPERTY WILL BE AFFECTED BY A NATURAL DISASTER. BUYER(S) AND SELLER(S) MAY WISH TO OBTAIN PROFESSIONAL ADVICE REGARDING THOSE HAZARDS AND OTHER HAZARDS THAT MAY AFFECT THE PROPERTY.

Check only one of the following:

☐ Seller and their agent represent that the information herein is true and correct to the best of their knowledge as of the date signed by Seller and Seller's Agent.

☐ Seller and their agent acknowledge that they have exercised good faith in the selection of a third-party report provider as required in Civil Code Section 1103.7, and that the representations made in this Natural Hazard Disclosure Statement are based upon information provided by the independent third-party disclosure provider as a substituted disclosure pursuant to Civil Code Section 1103.4. Neither seller nor their agent has independently verified the information contained in this statement and report or is personally aware of any errors or inaccuracies in the information contained on the statement. This statement was prepared by:

Third-Party Disclosure Provider:________________________ Date: ________

Date:__________, 20____	Date:__________, 20____
Seller: ____________________	Seller's Broker:____________________
Seller: ____________________	Agent: ____________________

Buyer represents that he has read and understands this document. Pursuant to Civil Code Section 1103.8, the representations made in this Natural Hazard Disclosure Statement do not constitutes all of Seller's or Seller's Agent's disclosure obligations in this transaction.

Buyer:________________________ Date: ________

Buyer:________________________ Date: ________

form or another is not optional. A natural hazard disclosure is mandated on all types of property. [CC §1103.1(b)]

All sellers, and any listing or selling agent involved, have an initial common law duty owed to prospective buyers to disclose conditions on or about a property which are **known to them** and might adversely affect the buyer's willingness to buy or influence the price and terms of payment he is willing to offer.

Natural hazards, or the lack thereof, irrefutably affect a property's value and desirability to a prospective buyer. If a hazard is known to any agent (as well as the seller) or noted in public records, it must be disclosed to the prospective buyer before he agrees to purchase the property. If not disclosed, the buyer can cancel the transaction, called *termination*. And if the transaction has closed escrow, the buyer may *rescind* the sale and be **refunded** his investment, called *restoration*. [**Karoutas** v. **HomeFed Bank** (1991) 232 CA3d 767]

Therefore, the need to prepare the seller's NHD statement in advance of locating a prospective buyer **must be anticipated** by the seller and listing agent.

If the need is not anticipated, the NHD will not be prepared, signed and available for delivery to prospective buyers before an offer is accepted or a counteroffer is made, all requisites to delivery of the NHD *as soon as practicable*. [Calif. Attorney General Opinion 01-406 (August 24, 2001); CC §1103.3(a)(2)]

Investigating the existence of a hazard

Natural hazard information must be obtained from the public records. If not obtained, the seller and listing agent cannot make their required disclosures.

To obtain the natural hazard information for delivery to prospective buyers, the seller and his listing agent are required to exercise *ordinary care* in gathering the information. They may gather the information themselves or the seller may employ an NHD expert to gather the information. The expert then prepares the NHD form for the seller and the listing agent to review, add any comments, sign and deliver to prospective buyers. [CC §1103.4(a)]

Thus, the seller and listing agent may obtain natural hazard information:

- directly from the public records themselves; or
- by employing a natural hazard expert, such as a geologist.

For the seller and the listing agent to rely on an NHD report prepared by others, the listing agent need only:

- **request** a NHD report from a reliable expert in natural hazards, such as an engineer or a geologist who has studied the public records (as some natural hazards clearly do not pertain to engineering or geology);
- **review** the NHD form prepared by the expert and **enter** any actual knowledge the seller or listing agent may possess, whether contrary or supplemental to the expert's report, on the form prepared by the expert or in an addendum attached to the form; and
- **sign** the NHD Statement provided by his NHD expert and **deliver** it with the NHD report to prospective buyers or buyer's agents. [CC §1103.2(f)(2)]

When prepared by an NHD expert, the NHD report must also note whether the listed property is located within 2 miles of an existing or proposed airport, an environmental hazard zone called an *airport influence area* or *airport referral area*. The buyer's occupancy of property within the influence of an airport facility may be affected by noise and restrictions, now or later, which may be imposed on the buyer's uses as set by the airport's land-use commission. [CC §1103.4(c)]

Also, the expert's report must note whether the property is located within the jurisdiction of the San Francisco Bay conservation and development commission.

Broker uses experts to limit liability

The Natural Hazard Disclosure scheme, while not making the practice mandatory, encourages brokers and their agents to use natural hazard experts rather than gather the information from the local planning department themselves. The use of an expert who himself relies on the contents of the public record to prepare his report relieves the listing agent of any liability for errors not known to the agent to exist.

Neither the seller nor any agent, be he the seller's or the buyer's agent, is liable for the erroneous preparation of a NHD Statement they have delivered to the buyer, if:

- the NHD report and form is prepared by an **expert in natural hazards**, consistent with his professional licensing and expertise; and
- the seller and listing agent used **ordinary care** in selecting the expert and in their review of the expert's report for any errors, inaccuracies and omissions of which they have **actual knowledge**. [CC §§1103.4(a), 1103.4(b)]

Neither the seller nor the listing agent need enter into an *indemnification agreement* with the natural hazard expert to avoid liability for errors. By statute, the expert who prepared the NHD is liable for his errors, not the seller or listing agent who relied on the report of a non-negligently selected expert to fulfill their duty to check the public records.

However, if brokers are sued based on the inaccuracy of the expert's report, an indemnity agreement entered into by the expert, given in exchange for the request to prepare a natural hazard report, will cover the cost of any litigation which might unnecessarily haul the broker into court.

The listing agent's dilatory delivery of an expert's NHD to the buyer or the buyer's agent, after the offer has been accepted, will not protect the broker from liability for the buyer's lost property value due to the nondisclosure before acceptance. If the agent **knew or should have known** of a natural hazard based on the readily available planning department's parcel list, he is exposed to liability. Liability exposure includes costs the buyer may incur to correct or remedy the undisclosed hazardous condition and that portion of the agreed price which exceeds the property's fair market value based on the undisclosed hazard. [CC §1103.13]

Further, the agents, seller and expert are not exposed to liability from **third parties** to the sale transaction who might receive their erroneous NHD Statement and rely on it to analyze the risk they undertake by their involvement. Such third parties include insurance companies, lenders, governmental agencies and others who may become affiliated with the transaction. [CC §1103.2(g)]

Documenting compliance with NHD law

Compliance by the seller and listing agent to deliver the NHD Statement to the buyer is required to be documented by a provision in the purchase agreement. [CC §1103.3(b); see **first tuesday** Form 150 §11.4]

However, should the listing agent fail to disclose a natural hazard and then provide in the purchase agreement for the compliance to be an untimely "in escrow" disclosure, his seller is statutorily penalized. The buyer, on an in-escrow disclosure, is allowed either a three-day right of cancellation should he be handed the NHD Statement, or a five-day right of cancellation should the NHD Statement be mailed to the buyer. [CC §1103.3(c)]

Further, delivery of the NHD after acceptance of an offer, when it could have been previously prepared by the seller or listing agent and timely delivered, imposes liability on the seller and listing agent, but not the buyer's agent. Liability is based on any money losses (including a reduced property value) inflicted on the buyer by the disclosure should the buyer choose not to exercise his right to cancel and instead proceed with the agreement and close escrow. [CC §1103.13; **Jue** v. **Smiser** (1994) 23 CA4th 312]

Delivery of the NHD to the buyer

It is the **buyer's agent** who has the duty to hand the buyer the NHD Statement the buyer's agent receives from the seller or the listing agent, called *delivery*. [CC §1103.12(a)]

The **buyer's agent**, on receiving the NHD form from the listing agent, owes the buyer a special agency duty to care for and protect his buyer's best interest by reviewing the NHD Statement himself for any disclosure which might affect the property's value or its desirability for his buyer. The buyer's agent is then required to deliver the NHD to the buyer and make any recommendations or explanations the buyer's agent may have regarding its content. [CC §§1103.2, 1103.12]

If the buyer does not have a broker, the seller's agent is responsible for delivering the NHD Statement to the prospective buyer.

However, the listing agent is not required to understand the effect hazards have on the property or the buyer. Also, the listing agent has absolutely no duty to voluntarily explain to a prospective buyer the effect a known natural hazard (which is itself disclosed) might have on the property or the buyer. The task of explaining the consequence of living with a natural hazard is the duty of a buyer's agent.

Delivery may be in person or by mail. Also, delivery is considered to have been made if the NHD is received by the spouse of the buyer. [CC §1103.10]

Sellers occasionally act as "For Sale By Owners" (FSBOs) and directly negotiate a sale of their property with buyers in transactions which exclude brokers and agents. Here, the seller is responsible for preparing or obtaining an NHD statement and delivering the NHD Statement to the prospective buyer.

No warranty, just awareness

A seller's NHD Statement is **not a warranty or guarantee** by the seller or listing agent of the natural hazards affecting the property. The NHD Statement is a report of the seller's and listing agent's (or the NHD expert's) knowledge (actual and constructive) of any natural hazards affecting the property.

However, the NHD Statement is relied on by prospective buyers. The NHD is designed to assist them in their decisions as to whether they should buy the property, and if they do decide to buy, at what price and on what terms. These conditions all need to exist before entering into a purchase agreement to avoid misleading the buyer, called *deceit*. [AG Opin. 01-406]

Disclosures concerning the value and desirability of a property, such as an NHD Statement, are **price-sensitive information**. Thus, the statement must be delivered to the prospective buyer before he enters into a purchase agreement in order to accomplish their intended result. If not timely disclosed, the seller and listing agent subject themselves to claims for price adjustments (offsets) which may be made by the buyer either before or after closing. Alternatively, the buyer may cancel the purchase agreement and have his deposit refunded.

Good brokerage practice would deliver the NHD to the prospective buyer on or before he makes an offer or accepts a counteroffer, while he is still the prospective buyer. Disclosures should not be made later when the prospect has become the buyer under a purchase agreement and entitled to ownership of the property at the price and on the terms agreed. Properly, the purchase agreement offer would then include a copy of the seller's NHD Statement as an addendum (along with all other disclosures), noting the transaction is in compliance with NHD law.

As for an **escrow officer** handling a sale in which the listing agent fails to provide the buyer's agent or the buyer with the NHD prior to opening escrow, the escrow officer has no duty to the seller or buyer to prepare, order out or deliver the NHD to the buyer. The obligation remains that of the seller and listing agent. However, escrow may accept instruction to perform any of these activities, in which case escrow becomes obligated to follow the instructions agreed to by the escrow officer. [CC §1103.11]

Excluded sellers, not agents

While all sellers of properties must disclose what is known to them about the natural hazards endemic to a property's location, sellers in some transactions **do not need to use** the mandated NHD form to make their disclosures, such as:

- court-ordered transfers or sales;
- deed-in-lieu of foreclosures;
- trustee's sales;
- lender resales after foreclosure or deed-in-lieus;
- estates on death;
- transfers between co-owners;
- transfers to relatives/spouses; or
- transfers to or by governmental entities. [CC §1103.1(a)]

However, any listing agent involved in an excluded transaction must himself make hazard disclosures, even though he does not need to use the statutory form. [CC §1103.1(b)]

Also, all sellers of any type of property, included or excluded, must, as always, disclose what **they know about any hazards**. Again, the disclosure is best accomplished by use of the NHD Statement on all sales. The NHD expert will definitely include the statement as part of his report. [CC §1103.2(f)(2)]

On properties not mandated to use the form, the listing agent can comply with his and his seller's duty to disclose by ordering a report from a natural hazard expert. On the listing agent's receipt of the expert's report, he will review the report (preferably with the seller), add what they know about hazards which are not included in the expert's report, sign the NHD statement accompanying the report and hand the entire NHD package to prospective buyers before an offer is submitted or a counteroffer made.

Other disclosure statements distinguished

The NHD Statement handed to a prospective buyer of one-to-four unit residential property is an additional disclosure unrelated to the environmental hazards and physical deficiencies in the soil or improvements located on or about a property as disclosed on Transfer Disclosure Statement (TDS) or in the purchase agreement. [See **first tuesday** Form 304 §C(1)]

The TDS discloses health risks resulting from **man-made** physical and environmental conditions affecting the use of the property. They are limited to facts known to the seller and listing agent without concern for a review of public records on the property at the planning department or elsewhere. The NHD Statement discloses risks to life and property which exist **in nature** due to the property's location and are known and readily available from the public records (planning department).

Other than one-to-four

Use of the statutory NHD form for hazard disclosures by sellers and their agents is mandated only on the sale of non-exempt, targeted one-to-four unit residential property. [CC §1103]

Thus, sellers and listing agents on all other properties do not need to use and deliver the statutory NHD form to prospective buyers of those properties. However, all sellers and their listing agents still have a duty to disclose hazardous conditions known to them to exist.

Sellers and listing agents of **any type of real estate** must disclose whether the property is located in:

- an area of potential flooding;
- a very high fire hazard severity zone;
- a state fire responsibility area;
- an earthquake fault zone; and
- a seismic hazard zone. [CC §1103.2]

Even though use of the form is not mandated for sales of property other than one-to-four residential units, agents best meet their hazard disclosure duty in all transactions by using the NHD Statement to convey their knowledge and information contained in public records. [CC §1103.1(b)]

Editor's note — The following discussion details the different hazards which must be disclosed on the NHD Statement.

Flood zones

Investigating flood problems was facilitated by the passage of the National Flood Insurance Act of 1968 (NFIA).

The NFIA established a means for property owners to obtain flood insurance with the National Flood Insurance Program (NFIP).

The Federal Emergency Management Agency (FEMA) is the administrative entity created to police the NFIP by investigating and mapping regions susceptible to flooding.

Any flood zone designated with the letter "A" or "V" is a *special flood hazard area* and must be disclosed as a natural hazard on the NHD Statement. [See Form 314 §1]

Zones "A" and "V" both correspond with areas with a 1% chance of flooding in any given year, called 100-year floodplains, e.g., a structure located within a special flood hazard area shown on an NFIP map has a 26% chance of suffering flood damage during the term of a 30-year mortgage.

However, Zone "V" is subject to additional storm wave hazards.

Both zones are subject to mandatory flood insurance purchase requirements.

Information about flood hazard areas and zones can come from:

- city/county planners and engineers;
- county flood control offices;
- local or regional FEMA offices; and
- the U.S. Corps of Engineers.

Additional information concerning flood hazard areas can be obtained in the Community Status Book. The book lists communities and counties participating in the NFIP and the effective dates of the current flood hazard maps available from FEMA.

The Community Status Book can be obtained via the web at: http://www.fema.gov/fema/csb.shtm.

Flood Insurance Rate Maps and Flood Hazard Boundary Maps are all available at the FEMA Flood Map store by calling (800) 358-9616 or via the web at: http://msc.fema.gov/.

Another flooding disclosure which must be made on the NHD Statement arises when the property is located in an area of **potential flooding**. [See Form 314 §2]

An area of potential flooding is a location subject to partial flooding if sudden or total **dam failure** occurs. The inundation maps showing the areas of potential flooding due to dam failure are prepared by the California Office of Emergency Services. [Calif. Government Code §8589.5(a)]

Once alerted by the listing agent to the existence of a flooding condition, the buyer's agent must inquire further to learn the significance of the disclosure to the buyer.

Very high fire hazard severity zone

Areas in the state which are subject to significant fire hazards have been identified as *very high fire hazard severity zones*. If a property is located in a very high fire hazard severity zone, a disclosure must be made to the prospective buyer. [See Form 314 §3]

The city, county or district responsible for providing fire protection have designated, by ordinance, very high fire hazard severity zones within their jurisdiction. [Gov C §51179]

The fire hazard disclosure on the NHD form mentions the need to maintain the property. Neither the seller nor the listing agent need to explain the nature of the maintenance required or its burden on ownership. Advice to the buyer on the type of maintenance and the consequences of owning property subject to the maintenance are the duties of the buyer's agent, if they have an agent.

For example, a buyer occupying a residence located in a very high fire hazard severity zone is advised by his agent that as the new owner, the buyer must:

- maintain a firebreak around the structure of a distance of no less than 30 feet or to the property line, whichever is nearer, unless the local agency requires up to 100 feet or more;
- remove tree branches extending within 10 feet of any chimney or stovepipe;
- clear dead or dying wood from trees adjacent to or overhanging the structure;
- remove leaves, needles or other dead vegetative growth from the roof; and
- maintain a screen over the chimney or stovepipe. [Gov C §51182]

State Fire Responsibility Areas

If a property is in an area where the financial responsibility for preventing or suppressing fires is primarily on the state, the real estate is located within a *State Fire Responsibility Area*. [Calif. Public Resources Code §4125(a)]

Notices identifying the location of the map designating State Fire Responsibility Areas are posted at the offices of the county recorder, county assessor and the county planning agency. Also, any information received by the county after receipt of a map changing the State Fire Responsibility Areas in the county must be posted. [Pub Res C §4125(c)]

If the property is located within a **wildland area** exposed to substantial forest fire risks, the seller or his listing agent must disclose this fact. If the property is located in a wildland area, it requires maintenance by the owner to prevent fires. [Pub Res C §4136(a); see Form 314 §4]

In addition, the NHD Statement advises the prospective buyer of a home located in a **wildland area** that the **state has no responsibility** for providing fire protection services to the property, unless the Department of Forestry and Fire Protection has entered into a cooperative agreement with the local agency. No further disclosure about whether a cooperating agreement exists need be made by the seller or listing agent. [See Form 314 §4]

However, if property disclosures place the property in a wildland area, the buyer's agent has the duty to advise the buyer about the need to inquire and investigate into what agency provides fire protection to the property.

Earthquake fault zones

To assist seller's agents in identifying whether the listed property is located in an earthquake fault area, maps have been prepared by the State Geologist.

The State Mining and Geology Board and the city or county planning department have maps available which identify special studies zones, called *Alquist-Priolo Maps*. [Pub Res C §2622]

The maps are used to identify whether the listed property is located within one-eighth of a mile on either side of a fault.

Also, the NHD Statement requires both the seller and the listing agent to disclose to a prospective buyer or the buyer's agent whether they have knowledge the property is in a fault zone. [See Form 314 §5]

Seismic hazards

A *Seismic Hazard Zone* map identifies areas which are exposed to earthquake hazards, such as:

- strong ground shaking;
- ground failure, such as liquefaction or landslides [Pub Res C §2692(a)];
- tsunamis [Pub Res C §2692.1]; and
- dam failures. [Pub Res C §2692(c)]

If the property for sale is susceptible to any of the earthquake (seismic) hazards, the seismic hazard zone disclosure on the NHD Statement must be marked "Yes." [See Form 314 §6]

Seismic hazard maps are not available for all areas of California. Also, seismic hazard maps do not show Alquist-Priolo Earthquake Fault Zones. The California Department of Conservation creates the seismic hazards maps.

The seismic hazard maps which exist are on the web at http://www.consrv.ca.gov/shmp/.

If the NHD indicates a seismic hazard, the buyer's agent must then determine which type of hazard, the level of that hazard and explain the distinction to the buyer, or see to it that someone else does. The listing agent has no such obligation to the buyer.

For example, property located in Seismic Zone 4 is more susceptible to **strong ground shaking** than areas in Zone 3. But which zone the property is located in is a question the buyer's agent must answer. Most of California is in Zone 4, except for the southwest areas of San Diego County, eastern Riverside and San Bernardino Counties, and most of the Northern California Sierra Counties.

Homes in Zone 4 can be damaged even from earthquakes which occur a great distance away.

Ground failure is a seismic hazard which refers to landslides and liquefaction. Liquefaction occurs when loose, wet, sandy soil loses its strength during ground shaking. Liquefaction causes the foundation of the house to sink or become displaced. The condition is prevalent in tidal basins which are fills.

A **tsunami** is a large wave caused by an earthquake, volcanic eruption or an underwater landslide. Coastal areas are the ones at risk for loss of property and life.

Tsunami inundation maps are available from the National Oceanic and Atmospheric Administration (NOAA) led National Tsunami Hazard Mitigation Program (NTHMP) at: http://www.pmel.noaa.gov/tsunami-hazard.

Also, FEMA's Flood Insurance maps consider tsunami wave heights for Pacific coast areas.

Dam failure results in flooding when an earthquake causes a dam which serves as a reservoir to rupture. The city or county planning department has maps showing areas which will be flooded if a local dam fails.

Areas susceptible to inundation due to dam failure caused by an earthquake are also noted on the NHD Statement as a potential flooding area.

Chapter 12 — Lead-based paint disclosures

This chapter evaluates the lead-based paint hazard disclosure mandatory on the sale of all residential housing built prior to 1978 and the risks of accepting a buyer's purchase agreement offer before disclosure

Crystal clear transparency

An agent, while soliciting an owner of a residential property to employ the agent's broker to market and locate a buyer for the property, gathers facts about the property, its ownership and its likely market value.

As the agent predicted, the property profile furnished by a title company confirms the agent's suspicion that the structure was built **prior to 1978**. The agent is now aware the property is the target of separate state and federal environmental protection disclosure programs designed to prevent the poisoning of children by the presence of lead-based paint.

The agent sets up a meeting with the owner to review the requisite listing and marketing requirements laid down by his broker, and the owner's expectations for a listing price and an acceptable sales price. To prepare for the meeting, the agent fills out the listing agreement and attaches all the disclosure forms needed to correctly market and sell the property, called a *listing package*.

Among other informational forms, the agent includes two forms which address **lead-based paint conditions** on the property:

- the Federal Lead-based Paint (LBP) disclosure [See Form 313 accompanying this chapter]; and
- the California Transfer Disclosure Statement (TDS). [See **first tuesday** Form 304]

At the presentation of the listing agreement, the agent explains the **seller's legal obligation**, owed to prospective buyers and their agents, to provide them with all the information known to the owner or known or readily available to the listing agent on inquiry regarding the property which adversely affects its value.

The objective of the listing agent's marketing effort is to provide prospective buyers with all known or readily available information about the property which may affect its value before the prospective buyer makes an offer. By making the transaction **fully transparent** to prospective buyers from the outset of negotiations, the renegotiation of the purchase agreement, including a demand for a price reduction, cancellation or a refund after closing due to further disclosures, is avoided. [**Jue** v. **Smiser** (1994) 23 CA4th 312]

A full disclosure to the prospective buyer about the property by the seller and the listing agent does not entail a review or explanation of the facts. Application of the facts disclosed and the potential consequences flowing from the facts which may affect the prospective buyer's use, possession or ownership of the property are not among the listing agent's duties of affirmative disclosure.

However, LBP rules do require the listing agent to advise the seller of the seller's pre-purchase agreement disclosure requirements. The listing agent must **insure compliance** by or on behalf of the seller before the seller enters into a purchase agreement.

*Editor's note — Regarding the LBP disclosures, the owner is properly informed he has no obligation to have his property inspected and have a report prepared on the presence of lead-based paint or any lead-based paint hazards. Also, the owner is advised he does not have to perform any **corrective work** to clean up or even eliminate the conditions, unless he agrees with the buyer to do so. [24 Code of Federal Regulations §35.88(a); 40 CFR §745.107(a)]*

Thus, the seller needs to cooperate in the LBP disclosure and his agent's marketing efforts by:

- filling out and signing the federal LBP disclosure form required on all pre-1978 residential constructions [See Form 313];
- filling out and signing the TDS containing the lead-based paint, environmental and other property conditions [See **first tuesday** Form 304];
- ordering or authorizing the listing agent to order a physical home inspection report to be made available to prospective buyers as an attachment to the TDS form; and
- providing the listing agent with copies of reports or documents known to the seller which contain information about the presence of lead-based paint or lead-based paint hazards on the property.

Lead-based paint and hazards

Lead-based paint was **banned** by the Federal Consumer Product Safety Commission in 1978.

Lead-based paint is defined as paint or other surface coating that contains lead equal to at least 1.0 milligram per square centimeter or 0.5% by weight. [24 CFR §35.86; 40 CFR §745.103]

A **lead-based paint hazard** is any condition that causes exposure to lead from lead-contaminated dust, soil or paint which has deteriorated to the point of causing adverse human health effects. [24 CFR §35.86; 40 CFR §745.103]

Editor's note — A list of statewide laboratories certified for analyzing lead in hazardous material, including paint, is available from the National Lead Information Center at (800) 424- LEAD. Lists are also available on the web at http://www.leadlisting.com/lead.html and http://www.dhs.ca.gov/childlead.

LBP disclosure content

The LBP disclosure form includes the following:

- the **Lead Warning Statement** as written in federal regulations [See Form 313 §1];
- the **seller's statement** disclosing the presence of known lead-based paint hazards or the seller's lack of any knowledge of existing lead-based paint [See Form 313 §2];
- a **list of records** or reports available to the seller which indicates a presence or lack of lead-based paint, which have been handed to the listing agent [See Form 313 §2.2];
- the **buyer's statement** acknowledging receipt of the LBP disclosure, any other information available to the seller and the lead hazard information pamphlet entitled *Protect Your Family From Lead in Your Home* [See Form 313 §3.1];
- the **buyer's statement** acknowledging the buyer has received a 10-day opportunity to inspect the property or has agreed to reduce or waive the inspection period [See Form 313 §3.2];
- the **listing agent's statement** noting the seller has been informed of the seller's disclosure requirements and that the agent is aware of his duty to ensure the seller complies with the requirements [See Form 313 §4]; and
- the **signatures** of the seller, buyer and listing agent. [24 CFR §35.92(a)(7); 40 CFR §745.113(a)(7)]

LEAD-BASED PAINT DISCLOSURE

On Sale of Real Estate

Property address:____

NOTE: For use on the sale of any residential property which was constructed pre-1978.

1. Lead Warning:

1.1 Every buyer of any interest in residential real property on which a residential dwelling was built prior to 1978 is notified that such property may present exposure to lead from lead-based paint that may place young children at risk of developing lead poisoning. Lead poisoning in young children may produce permanent neurological damage, including learning disabilities, reduced intelligence quotient, behavioral problems, and impaired memory. Lead poisoning also poses a particular risk to pregnant women.

1.2 The seller of any interest in residential property is required to provide the buyer with any information on lead-based paint hazards from risk assessments or inspections in the seller's possession and notify the buyer of any known lead-based paint hazards.

1.3 A risk assessment or inspection for possible lead-based paint hazards is recommended prior to purchase.

Items left blank or unchecked are not applicable.

2. Seller's Certification:

2.1 Presence of lead-based paint and/or lead-based paint hazards:

a. ☐ Are known to be present in the housing as explained:____

____

____

b. ☐ Are not known to Seller to be present in the housing.

2.2 Records and reports available to Seller:

a. ☐ Seller has provided Buyer with all available records and reports listed below pertaining to lead-based paint and/or lead-based paint hazards in the housing: _______________________________

____

____

b. ☐ Seller has no reports or records pertaining to lead-based paint and/or lead-based paint hazards in the housing.

Date:______________, 20______ Seller:____

Date:______________, 20______ Seller:____

3. Buyer's Acknowlegement:

3.1 Buyer has received:

a. ☐ Copies of all information listed above.

b. ☐ The pamphlet *Protect Your Family From Lead in Your Home*.

3.2 Buyer:

a. ☐ Will receive a ☐ 10-day or ☐ ______-day opportunity from acceptance of the purchase offer to conduct a risk assessment or inspection for the presence of lead-based paint and/or lead-based paint hazards.

b. ☐ Waives the opportunity to conduct a risk assessment or inspection for the presence of lead-based paint and/or lead-based paint hazards.

3.3 I acknowledge that I have read and understood the attached lead warning statement in Section 1 of this form and received all information noted in Section 2 of this form.

Date:______________, 20______ Buyer: ____

Date:______________, 20______ Buyer: ____

4. Broker's Certification (When Applicable):

4.1 Broker certifies to have informed Seller of his/her obligation under 42 U.S.C. §4852d to disclose to Buyer and Broker all information known to Seller regarding the presence of lead-based paint and lead-based paint hazards within this target housing and that all information known to Broker regarding the presence of lead-based paint and lead-based paint hazards within this target housing has been disclosed to Buyer.

4.2 Broker further certifies that Buyer has received the lead hazard information pamphlet *Protect Your Family From Lead in Your Home* and that Buyer has or will be given a 10-calendar-day period (unless otherwise agreed in writing) to conduct a risk assessment or inspection for the presence of lead-based paint before becoming obligated under the contract to purchase the housing.

Date:______________, 20______ Broker: ____

FORM 313 10-00

The seller and the listing broker must each keep a copy of the disclosure statement for at least three years from the date the sale is completed. [24 CFR §35.92(c); 40 CFR §745.113(c)]

Whether or not the LBP disclosure form is retained does not have an effect on the statute of limitations for the buyer to pursue misrepresentations or alter the buyer's right to post-contract disclosures. [24 CFR §35.92(c)(2); 40 CFR §745.113(c)(2)]

Also, the disclosure form must be in the language of the purchase agreement. For example, if the purchase agreement is in Spanish, then the LBP disclosure must also be in Spanish. [24 CFR §35.92(a); 40 CFR §745.113(a)]

Opportunity to evaluate risk

A prospective buyer must be notified before he makes an offer that he has the opportunity, by way of a **10-day period** after acceptance, to evaluate the hazardous risks involved due to the presence of lead-based paint in residential housing built prior to 1978. The buyer can agree to a **lesser period of time** or can entirely **waive** the right to the federally permitted risk evaluation period. [40 CFR §745.110(a)]

However, disclosures about the property cannot be waived, no matter the nature of the facts, data or information, by the use of an "as-is" sale provision.

Both the mandated lead-based paint disclosures and the notice of the waiveable right to a lead-based paint risk evaluation period are complied with by the use of the Federal LBP disclosure form. [See Form 313]

Pre-contract disclosure avoids cancellation

Consider a prospective buyer who indicates he wants to make an offer to buy pre-1978 residential property. The listing agent hands the prospective buyer a lead-based paint disclosure signed by the owner of the property which discloses that lead-based paint is known to exist on the property.

The prospective buyer is also handed independent reports and documents related to the existence of the lead-based paint on the property.

The prospective buyer enters into a purchase agreement offer, but does not waive the 10-day lead-based paint risk evaluation period, wishing instead to **inspect and confirm** the accuracy of the seller's disclosure since the seller's disclosure of the property condition is not a warranty guaranteeing the actual condition of the property.

After the seller's acceptance of the offer, the buyer has the property inspected. The inspector's report states lead-based paint exists as stated in the seller's disclosure documents. The buyer now seeks to cancel the purchase agreement due to the presence of lead-based paint.

Can the buyer refuse to complete the purchase of the property due to the existence of the lead-based paint as previously disclosed by the seller?

No! The buyer had full knowledge of the presence of lead-based paint and any lead-based paint hazards **prior to the seller's acceptance** of his purchase agreement offer. Thus, the buyer purchased the property **as disclosed** since the purchase agreement did not contain conditions calling for removal or abatement of the lead-based paint. The risk evaluation period only enabled the buyer to cancel had the seller not disclosed the presence of any lead-based paint or lead-based paint hazards prior to acceptance.

Thus, when the buyer entered into the purchase agreement, the buyer was put on notice about the presence of lead-based paint and the buyer could not later use the existence of lead-based paint as justification for cancellation.

Foreclosure sale exemption

Exempt from the Federal LBP disclosures are **foreclosure sales** of residential property. [24 CFR §35.82(a)]

Yet, a foreclosing lender still has a **common law duty to disclose known defects** at the foreclosure sale. Thus, even if the property is purportedly sold "as-is" at a foreclosure sale, a foreclosing lender is not protected from liability for intentional misrepresentation (negative fraud by omission) and deceit should the foreclosing lender have knowledge of a defect in the property and fail to disclose the defect at the time of the sale to the highest bidder. [**Karoutas** v. **HomeFed Bank** (1991) 232 CA3d 767]

However, the foreclosure exemption **does not apply** to the resale of housing previously acquired by the lender at a foreclosure sale, commonly called *real estate owned* (REO) property, or to the resale by a third party bidder who acquired the property at a foreclosure sale.

Thus, if a lender or other bidder who acquired property at a foreclosure sale is reselling it, the resale must comply with the lead-based paint disclosure requirements. [61 Federal Register 9063]

Chapter 13 Contingency provisions

This chapter reviews the inclusion of contingency provisions in purchase agreements to allow buyers and sellers to either confirm their expectations and meet objectives or avoid closing the transaction.

Conditioning the close of escrow

The contents of a purchase agreement is a collection of provisions generally called terms and conditions. While **terms** focus on the price and the (terms for) payment of the price, **conditions** address:

- the performance of **acts** by the buyer and seller respectively; and
- **events** which are to occur in the process of closing escrow on the transaction.

Thus, each condition addressed in a provision must either be shown to exist or come into existence, by its occurrence or approval, before the purchase agreement can be enforced and escrow closed. Alternatively, the condition can be *waived* as though never part of the purchase agreement.

Thus, all purchase agreements contain one or more provisions "conditioning" closing on the "elimination of a contingency."

When conditions are the subject of *contingency provisions*, the conditions are initially distinguished by whether they:

- do **occur** (events and activities), called *event-occurrence contingencies*; or
- are **approved** (information, data, documents and reports), called *further-approval* or *personal-satisfaction contingencies*.

These **contingency provisions** grant the buyer or seller, or both, the *power to terminate* any further performance of the purchase agreement should an identified activity or event fail to occur or a condition be disapproved.

Also, provisions containing **conditions** are further classified by the sequence or order in which they will be performed by the buyer or seller. Thus, the occurrence or approval called for is either:

- a *condition precedent* to the performance of an activity by the other person; or
- a *condition concurrent* to be performed without concern for the other person's activities.

Categorizing conditions still further, some conditions **must be performed**, making the failure to perform them and close escrow a *breach* of the purchase agreement. Other conditions are the subject of contingency provisions and **might not occur or be approved**, in which case the failure of one or both parties to further perform and close escrow is *excused*.

Thus, under any type of contingency provision, the buyer or seller benefitting from the contingency holds an **option** to "do away with" any further performance of the purchase agreement and escrow instructions, called *cancellation*.

Conditions precedent and concurrent

While all contingency provisions are conditions, it must be well understood that not all conditions agreed to in the provisions of a purchase agreement are contingencies. Contingency provisions authorize the cancellation of the purchase agreement and *excuse* any further performance. Other conditions must be met since they are not contingencies, in which case a failure becomes a *breach*.

For analysis, the two classifications of conditions which exist in purchase agreements, distinguished by whether or not the other person must perform or is excused due to the failure of the identified event to occur or condition (information) to be approved, are:

1. *Conditions precedent*, which consist of contingency provisions calling for the occurrence or approval of an event or condition which **may or may not occur**. Examples include the buyer obtaining a written loan commitment, the recording of a purchase-assist loan, approving due diligence investigations, etc. Here, the contingency provision may be *eliminated* and the transaction can proceed toward closing. Alternatively, if the event or approval is not forthcoming, the person authorized to cancel may *exercise* his right to terminate the transaction, doing away with any **further performance** of the purchase agreement and escrow instructions, called *cancellation*; and

2. *Conditions concurrent*, which consist of noncontingent, mandatory performance provisions calling for the buyer or seller to perform some activity which **must occur**. If the activity does not occur, the purchase agreement has been *breached* by the person who promised to perform or was obligated to cause the activity or event to come about. Examples include the failure of the seller to produce promised information, data, documents and reports on the property or deliver a clearance, grant deed or title insurance policy as agreed. The failure to deliver is a *breach* which allows the other person to either terminate the transaction by notice of cancellation or pursue specific performance of the purchase agreement.

Before escrow can proceed on to closing, contingency provisions must be *eliminated*. Contingency provisions (conditions precedent) included in purchase agreements are **eliminated** by either:

- *satisfaction* of the condition by either an **approval** of the data, information, documents or reports identified as the subject of the provision by the person holding the right to terminate the transaction, or by the **occurrence** of the event called for in the provision; or
- *waiver* (or expiration) of the right to cancel the transaction by the person authorized to cancel, if the identified condition or event has not been satisfied by its approval or occurrence.

Thus, the buyer or seller who has not been granted the power to terminate the transaction under a non-contingency provision, and thus cannot immediately cancel escrow to avoid his further performance, must perform all obligations of his remaining to be completed, called *conditions concurrent*. He must act without concern for the other person's performance under the purchase agreement, unless the other person must first perform some activity before he is able to comply, such as the seller providing a Natural Hazard Report before the buyer can review it and approve its contents.

The obligation of a buyer or seller to complete noncontingent (concurrent) activities required of him to close escrow exists in spite of the fact the other person may not have yet fully performed, or that the other person has a right to later cancel the purchase agreement. Examples include the inability of a buyer to originate a purchase-assist loan after the seller has fully performed by delivering all closing documents to escrow.

Content of a contingency provision

Regardless of the type of contingency involved, agents must make sure the contingency provision is in writing, even though oral contingencies are generally enforceable. Written contingencies avoid confusion over content, enforceability and forgetfulness.

Specifically, a written contingency should include:

- a description of the event addressed in the contingency (i.e., what is to be approved or verified);
- the time period in which the event called for in the contingency provision must occur;
- who has the right to cancel the purchase agreement if the event does not occur (i.e., whether the buyer, the seller or both can enforce the contingency provision by canceling the transaction);
- any arrangements to avoid cancellation if the contingency is not satisfied or waived (i.e., offsets to the price or time to cure the failure or defect); and
- the method for service of the notice of cancellation on the other person.

Provisions for uncertainties

An agent includes contingency provisions in a purchase agreement in an effort to protect his client from agreeing absolutely to do or cause something to occur which might not occur, or from being forced to accept a situation inconsistent with the client's expectations or ability to accomplish it at the time he enters into the purchase agreement.

Without authority to terminate the agreement on the failure of the client's expectations, such as the buyer's inability to record a purchase-assist loan or to confirm the seller's representations, the client's inability or refusal to continue to further perform under the purchase agreement and close escrow would be a *breach* of the purchase agreement by the client. Thus, the client would be liable to the other person, unless the client's nonperformance was justified by some pre-contract misrepresentation (and omission) of facts which led to the client's lost expectations, called *deceit*.

To avoid a **breach** and be **excused** from closing escrow when events and conditions develop during escrow which do not meet the expectations or anticipations of the client, his agent *conditionalizes* the client's continued performance by including contingency provisions in the purchase agreement. Due to the inclusion of a contingency provision, the client is authorized to terminate the agreement and avoid closing escrow on failure of the identified event to occur or the unacceptability of data, information, documents or reports.

But before lacing a purchase agreement with contingency provisions, or allowing the client to enter into one, a prudent agent will first attempt to clear uncertainties the client may have about the property or the transaction.

Use of contingency provisions

It is the buyer's agent who, along with buyers, is the primary user of contingency provisions in purchase agreements. From a buyer's point of view, and thus the buyer's agent's perspective, every activity, event or condition which is the responsibility of the buyer to review for approval or cause to occur so escrow can close should be the subject of a contingency provision in the purchase agreement.

Also for buyers, the period for exercise of the right to cancel should be as long as possible. Thus, the right to cancel should be structured to expire no earlier than the date scheduled for the close of escrow. The possibility always exists that the event or approval needed by the buyer to close escrow may never

occur. These conditions range, for example, from applying for purchase-assist financing or retaining consultants for advice on the value and integrity of the property, to making the down payment or providing personal identity information to the title insurance company.

When preparing the purchase agreement, the buyer's agent must rely on his experience to decide which events and approvals the buyer is responsible for and thus need to be the subject matter of a contingency provision. Then, if the event does not occur, such as the recording of mortgage financing, or are unacceptable, such as the failure of the property on a due diligence investigation to meet expectations, the buyer may cancel and be excused from proceeding. Thus, he can act to avoid closing and not be in default (breach) on the purchase agreement (or end up in a dispute claiming he has been misled).

There are many events and disclosures which are the subject of contingency provisions contained in stock forms used by agents. [See **first tuesday** Form 150 §11]

However, the boilerplate wording of pre-printed contingency provisions varies greatly regarding:

- the time for the gathering and delivery of data, information, documents and reports;
- the time period for review of the material received or the occurrence of an event (such as a loan commitment or sale of other property);
- the date set for expiration of the right to cancel the transaction after failure of the event or approval to occur;
- whether a written waiver is to be delivered evidencing the elimination of the contingency provision, without which the other party may then cancel;
- the requirement of a written notice of cancellation should the right to cancel be exercised on failure of an event or condition; and
- the time period for the other person's response to a notice of cancellation to cure the defect or failure, and thus avoid a termination of the purchase agreement.

Typically, several contingency provisions are included in a purchase agreement. Thus, a **uniform method** for terminating the agreement is employed. Termination provisions call for a written notice of cancellation, and how and to whom it is to be delivered, including instructions to escrow. [See **first tuesday** Form 150 §10.4]

Also, approval notices or waiver of contingency provisions need not be called for in purchase agreements. Contingency provisions are considered to be the grant of an **option to terminate** a transaction by exercise of the right to cancel prior to the *expiration* of the option period. Therefore, if the person authorized to cancel or who otherwise benefits from the inclusion of the contingency provision does not intend to use the provision to cancel, he does not need to do anything. He simply allows the "option period" for cancellation to expire.

The contingency is eliminated by the expiration of the right to cancel. Thus, a need never exists to approve or waive the contingency in order to do away with the right to cancel and proceed to close escrow, unless the purchase agreement wording states an approval or waiver is required to keep the contract alive. [**Beverly Way Associates** v. **Barham** (1990) 226 CA3d 49]

Conditions not contingent

The condition of the property, namely the physical integrity of the land and improvements, is frequently not disclosed to the buyer before entering into a purchase agreement. Most delayed disclosures fail to comply with the statutory mandates imposed on sellers and listing agents to hand the information to prospective buyers as soon as reasonably possible.

The listing agent has a mandated duty, owed to the public, to visually inspect the listed property and note his observations and awareness of property conditions adversely affecting the value on the seller's statutory disclosure document, called a Condition of Property or Transfer Disclosure Statement (TDS).

Not only is it **reasonably possible** for the listing agent to deliver the TDS before his seller enters into a purchase agreement with a buyer, it is mandated by case law and the economic imperatives of *transparency* to deliver property disclosures before a price is set in property transactions.

However, some stock purchase agreement forms convert the failure of the listing agent to deliver a TDS before the acceptance of an offer into a contingency, a statutorily imposed penalty placed on the seller for his tardy disclosures. As the subject matter of a contingency, the buyer is granted the right to cancel the transaction when the TDS is belatedly received.

If on review of the tardy disclosures the property conditions do not meet the expectations held by the buyer at the time he entered into the purchase agreement, the buyer may cancel the purchase agreement all due to the dilatory and misleading conduct of the listing agent, a type of fraud called *deceit*.

If not canceled, the buyer would become the owner of property which is not in the condition and of the value he was lead to believe and to think existed when he entered into the purchase agreement.

Now applying the same disclosure facts, consider a diametrically opposed purchase agreement provision designed to handle the listing agent's dilatory delivery of the TDS by not establishing a contingency, and therefore avoiding the need to cancel. Rather, the provision calls for the buyer to review the seller's and listing agent's post-acceptance property disclosures. The provision grants no one the authority to cancel should the property's conditions be unacceptable or less than expected when entering into the purchase agreement. Instead, it requires performance by all.

On the buyer's review of the TDS, if defects or other significant discrepancies in the property's condition are disclosed (which affect its value) and were not observed or known to the buyer before entering into the purchase agreement, the buyer is **authorized to notify** the seller of the defects and discrepancies and make a demand on the seller to cure them by repair, replacement or correction. If the buyer fails to give notice, he has let his right expire to demand the correction of previously undisclosed defects noted in the TDS and must proceed to close escrow. [See **first tuesday** Form 269]

However, if the buyer makes a demand on the seller to cure those defects first discovered by the buyer on his in-escrow review of the TDS, the seller is required to make the corrections before closing or suffer a reduction in the price equivalent to the cost to cure the noticed defects. Of course, the disclosure of the property's condition before the purchase agreement is accepted relieves the seller (and the buyer) of the need to activate this performance provision regarding repairs. [See **first tuesday** Form 150 §11.2]

Of course, the time set for delivery of data, information, documents and reports under a contingency provision so they can be approved or disapproved, as well as the date set for delivery of a notice of cancellation given for any valid reason, is always subject to *time-essence rules*. [**Fowler** v. **Ross** (1983) 142 CA3d 472]

Failure to close is a breach, unless excused

Frequently, a contingency provision calls for two events to occur in tandem, i.e., a condition concurrent, which **must occur**, followed by a condition precedent (approval), which **may or may not occur**.

For example, a seller of a condominium is to first provide documents on the homeowners' association (HOA) to the buyer (the condition concurrent) for what then becomes the buyer's review (the condition

precedent). Here, the seller **must deliver** the documents as a prerequisite to the buyer's review of their content for approval or disapproval. The seller must obtain the documents or otherwise cause them to be handed to the buyer. If he does not, the seller has *breached* the provision and the purchase agreement. [See Form 150 §11.8]

As for the buyer who receives the documents, he must then enter upon a *good-faith review* of their content under his further-approval portion of the contingency provision. After the review and completion of any further inquiry or investigation into their content, the buyer is to either express his approval by waiving or letting the right to cancel expire, or, if he has good reason and an honest belief that he cannot approve of their content, disapprove the documents by canceling the transaction.

Here, the seller is obligated to get the documents and deliver them to the buyer without concern for what steps the buyer may or may not be taking to perform any of his obligations under the purchase agreement, such as applying for a loan, providing a credit report or approving disclosures he has received. In practice, disclosures should be handed to the buyer for review and approval before entering into a purchase agreement since the information may adversely affect value requiring disclosure by the seller and the listing agent.

Consider another **tandem-events provision** in which the buyer will execute a promissory note in favor of the seller in a carryback transaction. The buyer, in a *further-approval contingency provision*, agrees to prepare and hand the seller a credit application. On receipt, the seller is to review and then approve, or cancel the transaction if the seller has a reasonable basis for disapproving the buyer's creditworthiness.

The buyer's obligation to deliver the credit application is a compulsory event he is required to perform. The failure to deliver is a *breach* of the provision since the buyer's delivery of the application is not conditioned on anyone first doing something.

On the other hand, the seller on receipt of the credit application is required to review the buyer's creditworthiness. However, he is not required to approve the buyer's creditworthiness, and if disapproved based on reasonable grounds, the seller is *excused* from closing escrow by canceling the transaction. [See **first tuesday** Form 150 §8.5]

Act to close without concern

Other contingency provisions require one person, such as the buyer, to first enter upon an activity (such as signing and returning escrow instructions) without concern for whether the other person, such as the seller, is performing his required obligations, such as obtaining a pest control clearance, an occupancy certificate, the release or reconveyance of liens on title, etc.

For example, a purchase agreement contains a contingency provision calling for the buyer to obtain and record a purchase-assist loan. Should the buyer fail to originate the loan as anticipated, the buyer may cancel the transaction and be *excused* from further performing. However, the buyer is obligated to promptly initiate the loan application process without concern for whether the seller has commenced any performance of the seller's obligations, such as signing and returning the seller's escrow instructions, providing a deed or ordering out inspections and reports required to be obtained by the seller. [**Landis** v. **Blomquist** (1967) 257 CA2d 533]

A person's performance of an activity which **must occur**, versus his undertaking to bring about an event or approve a condition which **may or may not occur**, is an important distinction to be made. One is a *breach* of the purchase agreement should the activity not occur; the other *excuses* any further perfor-

mance by cancellation should the described event not occur. Both failures permit the purchase agreement to be canceled by the opposing party, but a breach carries with it **litigation and liability exposure**.

For example, the buyer of a nonresidential income property is willing to purchase the property only if the seller can cancel a disadvantageous lease held by a tenant. The buyer's agent prepares a purchase agreement with a provision calling for the seller to deliver title and assign all existing leases except the one the buyer is unwilling to accept.

While the seller believes he can negotiate a cancellation of the lease, the listing agent does not want his seller committed to delivering title and then fail to be able to negotiate the cancellation of the lease. To accept the purchase agreement with the provision calling for delivery of the title clear of the lease would place the seller in breach if he could not negotiate a cancellation of the lease. Thus, the seller would be exposed to liability for the decrease in the value of the property resulting from the lease remaining as a defect (i.e., an unapproved encumbrance) on the title.

Here, the seller should submit a counteroffer prepared by the listing agent calling for the delivery of title to be contingent on the seller's termination of the lease, an **event-occurrence contingency provision**. Thus, the seller will only become obligated to make a good-faith effort to negotiate the cancellation of the lease. Should he fail to be able to deliver title clear of the lease, he may cancel the transaction and be *excused* from any further performance, and, importantly, be free of any liability for the failure to deliver title as agreed.

Performing without concern

Many contingency provisions authorize the buyer to exercise his right to cancel at any time up to and including the date scheduled for closing should the identified condition or event fail to occur. In the interim, the seller must fully perform all of his obligations to deliver to escrow all documents needed from the seller to close. After the seller has fully performed, the buyer, at the time of closing, may then cancel on failure of the condition or event.

The only rights a seller has in the buyer's contingency provision is the assurance that the buyer must act on any cancellation before the right to cancel expires, and that the cancellation is reasonable and the result of a good-faith effort by the buyer to satisfy the contingency so the transaction can close.

Consider a purchase agreement with terms for the payment of the purchase price which include having the buyer obtain a purchase-assist loan. The close of escrow is contingent on the buyer recording the loan since the buyer has the right to cancel if payment of the price cannot be funded by a purchase-assist loan. [See **first tuesday** Form 150 §10.3]

However, the seller has not handed escrow any of the documents or information requested by escrow, the receipt of which is needed to close escrow. The buyer then refuses to submit his loan application and fees until the seller has fully performed all his obligations for escrow to close. The buyer claims it is futile for him to proceed if the seller has not performed.

In turn, the seller cancels the transaction, claiming the buyer has breached his duty to make a good-faith effort to eliminate the loan contingency by applying for the loan.

Here, the buyer's obligation to take steps to satisfy the loan contingency and the seller's obligation to deliver deeds, termite clearances, etc. to escrow are independent obligations called *conditions concurrent*. Thus, the buyer and seller must each perform their part of the closing activities without concern for whether the other person has or is performing.

Also, the seller must, by the date scheduled for close of escrow, have fully performed all the acts required of the seller for escrow to close, and perform them in a timely manner for escrow to close on the date scheduled. The seller must comply even though the buyer's right to terminate the transaction can be exercised by canceling the escrow as late as the date scheduled for closing. [Landis, *supra*]

Sellers who agree to loan contingency provisions for buyers often require a separate and specific time-essence contingency provision to assure themselves that the buyer will act promptly to arrange a loan. In the provision, the buyer authorizes the seller to cancel the transaction if the buyer does not produce a loan commitment or a statement from a qualified lender by a specific date demonstrating that the buyer is qualified for a loan in the amount sought. Now, if the buyer fails to timely act on an application to negotiate a loan and arrange for a statement of his creditworthiness to be handed to the seller by the deadline for satisfaction of the condition, the seller may cancel the transaction.

Purchase agreement as binding

The existence of an oral or written contingency provision in a purchase agreement does not render the agreement *void*, as though it were a mere illusory contract which never was binding.

On the contrary, when an offer is accepted, a *binding agreement* is formed. The overriding issue on forming a binding purchase agreement which contains a contingency provision is whether the purchase agreement will ever **become enforceable** by the elimination of contingencies as satisfied or waived.

For example, the board of directors of a corporation decides the company needs to purchase a warehouse to store inventory. To meet the corporate objectives, the president, on behalf of his corporation, employs a broker who locates a suitable building. It appears the property will be sold to another person before board approval can be obtained authorizing the corporation to enter into a purchase agreement to acquire it.

As the agent authorized to bind the corporation to perform under a purchase agreement, the president, on behalf of the corporation, submits a signed purchase agreement offer to the listing agent agreeing to buy the real estate, conditioned on the **further approval** of the board of directors within 20 days of acceptance.

The seller accepts the offer after his listing agent explains the purchase agreement will not be enforceable until the board of directors approves the purchase, and thus *eliminates* the contingency.

The corporation, based on the offer submitted by its president and the seller's acceptance, has effectively taken the seller's property off the market while the president completes his due diligence investigation. Further, the board gets a "free look" by controlling the property before deciding on the property's suitability as a warehouse, or whether the terms of the purchase agreement are acceptable.

Here, the seller has a binding commitment from the corporate buyer to purchase the real estate, subject to presenting the purchase agreement and the property selection to the board for approval or rejection and cancellation under the contingency provision. [**Moreland Development Company** v. **Gladstone Holmes, Inc.** (1982) 135 CA3d 973]

However, the officers and board of directors of any corporate buyer or seller must act in *good faith* when exercising a contingency provision by cancellation. Accordingly, the officers need to submit the purchase agreement transaction to the board. The board then needs to review the purchase agreement. If conditions are unacceptable, the board should reject the purchase agreement in a resolution so the officers can show a reasonable basis exists for exercising the corporation's rights under the contingency provision to disap-

prove of the property selection or the terms of purchase and cancel the transaction. [**Jacobs** v. **Freeman** (1980) 104 CA3d 177]

Now consider a corporate owner of real estate who agrees to sell contingent on the **further approval** of the transaction by its board of directors prior to close of escrow. The corporate officers deliberately fail to submit the agreement for board approval since they no longer want to sell the property to this buyer. They cancel the sales transaction, believing they can do so for lack of board approval.

The buyer demands the corporation close escrow on the purchase agreement, claiming the agreement was breached by the failure to deliver a deed to the property when the agreement was never presented to the board of directors for approval as required by the contingency provision in the agreement.

The corporate seller claims the purchase agreement was properly cancelled since the board of directors did not approve the sale.

Here, the corporation cannot use the lack of board approval as a basis for canceling the purchase agreement. The board never disapproved the purchase agreement since the corporate officers failed to submit the purchase agreement to the board for approval. However, the cancellation would be valid if the corporate officers could show why submitting the agreement to the board for approval would have been futile. [**Jacobs** v. **Tenneco West, Inc.** (1986) 186 CA3d 1413]

In a real estate syndication context, consider a manager of a limited liability company (LLC) who submits a purchase agreement offer on behalf of his LLC to buy property (or accept an offer to sell), contingent on the further approval of the terms of the purchase agreement by the LLC members as required by the LLC operating agreement.

As a further-approval contingency, the LLC's inclusion of the provision in the purchase agreement offer is comparable to the situations calling for a corporate officer to act in good faith and submit the purchase agreement to their board of directors for approval (or disapproval). Thus, if the purchase agreement offer is accepted, the manager will submit the binding agreement to the members for a vote. If the members vote to disapprove, the manager will cancel the transaction rendering the purchase agreement unenforceable.

Chapter 14 — Arbitration: the independent beast

This chapter presents the adverse impacts created by agreeing to a binding arbitration clause in a real estate purchase agreement.

Rights to correct a decision lost

The trend among real estate agents regarding dispute resolution, encouraged since 1978 by trade unions, arbitration associations and the courts, has been to avoid the California court system by agreeing to resolve disputes involving the purchase or leasing of real estate and agency relationships through *binding arbitration*. The wisdom of this trend in real estate related contracts is under increasing attack.

Many pre-printed brokerage and purchase agreements include a boilerplate **arbitration provision**. The arbitration provision included in a purchase agreement, listing or lease agreement **forms a contract** with an arbitrator. Thus, the provision forms an agreement between the person who initials the provision and the arbitrator, an agreement separate from the purchase agreement which contains the provision. [**Prima Paint Corporation** v. **Flood & Conklin Mfg. Co.** (1967) 388 US 395]

To be enforceable, the arbitration provision must be initialed by the person against whom the provision is being enforced. Thus, an arbitration provision is enforceable against any person who initials the provision, even if the person is the only one to initial it. [**Grubb & Ellis Company** v. **Bello** (1993) 19 CA4th 231]

Editor's note — **first tuesday's** *purchase agreements and addenda do not contain either an arbitration provision or an attorney fee provision as a matter of policy to reduce disputes by making them less economically feasible*.

An **arbitration provision** in a real estate purchase agreement, listing or lease:

- is an arbitration agreement between the arbitrator and each person who agrees to be bound by the provision; and
- defines the arbitrator's powers and the limitations on those powers. [Calif. Code of Civil Procedure §1297.71]

The rights of the person agreeing to arbitration are established by the incorporation in the provision of arbitration statutes, applicable law limitations and discovery policies. Also controlling are the rules adopted by the arbitrator named in the provision, such as the American Arbitration Association.

Unless the arbitration provision states an arbitration award is "subject to judicial review," the award resulting from arbitration brought under the clause is **binding and final**. Without judicial review of an award in an arbitration action, the parties cannot be assured the award will be either **fair or correct**.

Arbitration's hype

Arbitration proceedings are reputed to be swifter and less costly than trials. Also, arbitrating disputes rather than litigating them eases the burden on the court system, and thus the taxpayer. Further, a public airing of "dirty laundry" produced in court filings and proceedings is avoided.

However, arbitration does not always live up to its reputation for being inexpensive or expedient. Filing fees for arbitration are high compared to filing fees for litigation. Unlike judges who are paid by the taxpayer, the arbitrator's charges must be paid by the loser. Additionally, the winner's attorney fees are paid by the loser when an attorney fee provision exists in the purchase agreement, lease or listing agreement involved.

Arbitration proceedings draw out for years when the dispute becomes complicated, just as in litigation. Also, a legitimate disagreement with the arbitrator's award as inconsistent with controlling California law, when called for in the powers granted the arbitrator by the arbitration provision, frequently leads to litigation in an effort to get the result attainable had the action been filed in a court of law in the first place.

Bizarre results not correctable

Consider a seller who contacts a brokerage office to list his property for sale. The sales activity is delegated to the broker's agent who procured the listing, customarily called the *listing agent*.

The seller and listing agent sign a listing agreement containing a provision calling for disputes to be submitted to binding arbitration — no judicial oversight permitted.

A buyer is located and an offer is obtained by another agent employed by the same broker, customarily called the *selling agent*. Both the agents and the broker are aware the buyer is financially unstable and may encounter difficulties closing the transaction. However, confirmation of the buyer's creditworthiness and net worth are not made the subject of a contingency provision by the selling agent who prepared the offer for the buyer. A contingency would have authorized the seller to cancel the purchase agreement if the buyer's credit had been found to be unsatisfactory.

When the listing agent, acting alone, submits the buyer's offer to the seller, the buyer's financial status is not discussed or disclosed, orally or in writing. The supervising broker fails to catch or correct the oversight.

The seller accepts the purchase agreement offer which provides for payment of a fee to the broker. Each agent will receive a share of any fee their broker may receive on the sale. Each agent's share is based on formulas agreed to in their respective written employment agreements with the broker.

Later, the buyer fails to close the transaction due to his disabling financial condition. The seller discovers that the listing agent, broker and selling agent all knew of the buyer's financial condition and failed to advise him of this fact. The seller makes a demand on the broker and both agents for his losses on the failed transaction, claiming the buyer's financial condition was a material fact in the transaction which the agents and broker knew about and failed to disclose.

The dispute is submitted to binding arbitration since a court action is barred by the arbitration provision in the listing agreement.

The arbitrator awards money damages to the seller based on the professional misconduct of the listing agent and employing broker for failure to disclose their knowledge of the buyer's unstable financial status — the broker being *vicariously liable* as the employer of the listing agent who failed to disclose.

Further, the arbitrator issues the seller a money award against the selling agent ruling the selling agent and the listing agent were "partners" since they would share in the fee the broker was to receive on the

transaction. Thus, the selling agent is held *liable as a partner* of the listing agent for the seller's money damages resulting from the misconduct of the listing agent.

The selling agent then seeks to vacate the portion of the arbitration award holding him liable as a "partner" of the listing agent, claiming the arbitrator incorrectly applied partnership law to a real estate agency and employment relationship.

Can the award against the selling agent be corrected by a court since the arbitrator wrongfully applied partnership law?

No! An arbitrator's award, based on an erroneous application of law, is **not subject to judicial review** since a judicial review of the arbitrator's award was not included as a condition of an award in the arbitration provision. The arbitrator acted within his powers granted by the arbitration provision, even though he applied the wrong law and produced an erroneous result.

A court of law confronted with a binding arbitration agreement cannot review the arbitrator's award for **errors of fact or law** even if the error is obvious and causes substantial injustice. [**Hall** v. **Superior Court** (1993) 18 CA4th 427]

Grounds for correction

Any defect in an arbitrator's award resulting from an error of fact or law, no matter how flagrant, is neither reviewable nor correctable, unless:

- the arbitrator exceeded his authorized powers;
- the arbitrator acted with fraud or corruption;
- the arbitrator failed to disclose grounds for his disqualification;
- the award was procured by corruption, fraud or other misconduct; or
- the refusal of the arbitrators to postpone the hearing substantially prejudiced the rights of the party. [CCP §1286.2]

An arbitrator, unlike a judge in a court of law, is not bound by the rules of law when arbitrating a dispute. Even when the arbitrator agrees to follow applicable California law, his erroneous award, unlike an award of a court, cannot be corrected by any judicial review. The arbitrator's award is final and binding on all parties, unless:

- the parties have agreed the arbitrator's award is subject to "judicial review;" or
- the arbitrator applied the wrong law and in so doing exceeded his powers which had been limited to applicable law.

Otherwise, no judicial oversight exists, by petition or appeal, to correct an arbitrator's erroneous award.

The arbitrator's award

Consider a buyer and seller of real estate who enter into a purchase agreement on a form which contains an arbitration clause. They both initial the provision.

Prior to closing, the seller discovers the property has significantly greater value than the price the buyer has agreed to pay in the purchase agreement, a condition brought about by a sharply rising real estate market.

Motivated by his belief the property's value will continue to rise to price levels other buyers will be willing to pay, the seller refuses to close the sale.

The buyer files a "demand for arbitration" with the arbitrator, claiming the seller breached the purchase agreement. The buyer seeks only to recover his **money losses** amounting primarily to the difference between the purchase price he agreed to pay for the property and the increased value of the property on the date of the seller's breach, called *money damages*.

The buyer no longer wants the property and does not seek specific performance of the purchase agreement, even though the seller still owns the property.

Prior to completion of the arbitration hearings, the value of the property drops significantly due to a cyclical local economic downturn.

The arbitrator then issues an award in favor of the buyer.

However, the arbitrator does not award the buyer his money losses as asked for by the buyer. The arbitrator is aware the property's current value has fallen below the sales price agreed to in the purchase agreement and the increased value at the time of the seller's breach.

Instead of the requested money award, the arbitrator's award grants the buyer the right to purchase the property for a price equal to its current fair market value.

The buyer now petitions the court to vacate the arbitration award and remand the case for a money award as requested in the arbitration. The buyer claims the arbitrator exceeded his powers by awarding a result not contemplated by the purchase agreement nor sought by the parties, i.e., the right to acquire the property at a different price even though the buyer does not want to acquire the property.

Did the arbitrator exceed his powers, act corruptly or prejudice the rights of the parties by awarding an *equitable remedy* (specific performance) which was in conflict with the purchase agreement (different price) and beyond any expectations of either the buyer or the seller?

No! The arbitrator was not corrupt and did not exceed his powers in awarding the buyer the right to purchase the property at its current market value. The erroneous award was drawn from the arbitrator's (mis)interpretation of the purchase agreement and the law.

Basically, the remedy awarded a buyer by an arbitrator in binding arbitration is not reviewable by a court of law, as long as the remedy has "some remotely conceivable relationship" to the contract. [**Advanced Micro Devices, Inc.** v. **Intel Corporation** (1994) 9 C4th 362]

When individuals enter into a purchase agreement, each person has expectations about his and the other person's performance as defined by the terms of the agreement and set by existing law.

Yet by agreeing in the purchase agreement to binding arbitration, not only is a person forced to accept an arbitrator's incorrect application of law, he is forced to proceed with arbitration and accept an award impossible to predict.

As the dissent in *Advanced Micro Devices, Inc.* points out, a bizarre interpretation by an arbitrator of the agreement underlying a dispute, coupled with a blatant error of law, might result in an arbitration award "ordering the marriage of the disputing parties' first- born children."

An arbitrator has great latitude in making decisions since he may use his own discretion and does not need to follow the mandates of regulations and case decisions.

Arbitrator's authority to enforce

Consider two partners in a real estate venture whose partnership agreement contains a boilerplate arbitration clause stating any dispute arising out of the agreement will be submitted to binding arbitration without judicial review.

On dissolution of the partnership, a dispute arises regarding disposition of the property, which is arbitrated. On issuing the award, the arbitrator includes the appointment of a receiver to supervise the sale of the partnership's property, rather than an award limited to calling for the property to be sold.

One of the partners seeks to vacate the arbitration award claiming the arbitrator exceeded his powers by appointing a receiver to sell the partnership's property.

Did the arbitrator exceed his powers by appointing a receiver to enforce his award?

Yes! The portion of the arbitration award appointing the receiver is invalid. An arbitrator lacks authority to **enforce his award** for the sale of the property, which is what the appointment of the receiver is designed to do.

The arbitration award must first be reduced to a court-ordered judgment before enforcement. On issuing an award, the person receiving the award files a petition with the court to **confirm** the award. On confirmation at a hearing on the petition, judgment is entered in conformance with the award.

It is the **judgment** which is enforced, not the arbitrator's award.

Although an arbitrator is not bound to follow the law when issuing an award, an arbitrator **exceeds his powers** when he attempts to also enforce his award — conduct reserved for a court of law after the award has been reduced to a judgment by the court. [**Marsch** v. **Williams** (1994) 23 CA4th 238]

An arbitrator also exceeds his powers when he **imposes fines** on a party to an arbitration for failure to comply with the arbitration award. An arbitrator does not have the power to impose **economic sanctions**, such as penalties and fines.

However, had the arbitration agreement authorized the arbitrator to appoint a receiver or impose fines, the arbitrator then has the power to do so, despite the general prohibition barring arbitrators from enforcing their awards. [**Mastrobuono** v. **Shearson Lehman Hutton, Inc.** (1995) 514 US 52]

Attorney fees as a power

Now consider a buyer and seller who enter into a real estate purchase agreement containing both an arbitration provision and an attorney fee provision. The attorney fee provision entitles the buyer or seller who prevails in an action to be awarded his attorney fees.

The buyer terminates the purchase agreement and seeks to recover all his transactional costs, claiming the seller has breached the agreement. As agreed, the dispute is submitted to binding arbitration. The arbitrator rules in favor of the seller, but denies the seller's request for attorney fees as called for under the attorney fee provision in the purchase agreement.

The seller seeks a correction of the arbitration award in a court of law claiming the arbitrator exceeded his powers by denying an award of attorney fees as agreed in the purchase agreement.

Here, the arbitrator did exceed his powers by failing to award attorney fees. The seller as the prevailing party was entitled to an award of attorney fees by a provision in the purchase agreement which was the subject of the arbitration. If the agreement underlying the dispute contains an attorney fee provision, the arbitrator must award attorney fees to the prevailing party. [**DiMarco** v. **Chaney** (1995) 31 CA4th 1809]

The attorney fee dilemma has a flip side. Not only must the arbitrator award attorney fees to the winner if the recovery of fees is called for in the purchase agreement, the arbitrator must determine the amount of the attorney fees to be awarded, an amount which is not subject to court review. [DiMarco, *supra*]

Avoiding arbitration

Consider a broker or agent who becomes a member of a local trade association. As part of the membership agreement, he agrees to binding arbitration for disputes arising between himself and other association members.

The arbitration panel who hears and decides disputes between members is composed of other members of the local association who have little to no legal training.

These local arbitration panels frequently base their decisions on moral or social beliefs and local customs they have personally adopted, rather than on controlling legal principles. Preference and bias towards a particular member of the association is more likely since the members of the arbitration panel are acquainted with or know about the members involved in the dispute. Yet, these panels are to consist of "neutral" arbitrators.

The panels are also very much aware the decisions they render are not appealable or reversible. Their award is final and binding.

However, the primary problem with arbitration proceedings heard by a local association's arbitration panel is the feeling held by most brokers and agents who are compelled to arbitrate that they are being railroaded through a process that disregards their rights, whether or not they are violated.

Further, by becoming a member of a local trade association, brokers and agents are forced to relinquish their rights to a court trial and an appeal to correct an erroneous decision rendered in disputes with other members.

However, brokers and agents employed by a broker who is an association member can avoid the complications imposed on them by membership. To do so and still comply with their broker's demand to satisfy the local trade association's annual monetary demands arising out of their association with the broker, they can pay "nonmember dues" and become "paid nonmembers." [**Marin County Board of Realtors, Inc.** v. **Palsson** (1976) 16 C3d 920]

Chapter 15 — Time to perform

This chapter sets out the enforceability of one party's right to cancel a transaction when the other party fails to perform by an appointed date.

Default and cancellation

The short, seemingly harmless time-is-of-the-essence provision stands alone amongst the boilerplate provisions of some, but not all, stock purchase agreement forms used to buy and sell real estate in California. By its plain words, the existence of a time-essence provision **gives notice** to the buyer and seller that their compliance by the date scheduled for an event to occur or a condition to be met as called for in the purchase agreement or escrow instructions is **essential to the continuation** of the transaction.

Thus, the bargain built into the purchase agreement by the presence of the time-essence provision gives the buyer or seller the right to **immediately cancel** the transaction on the failure of an event to occur or the other person to meet a condition by the appointed date. By virtue of the multiple number of tasks a typical buyer undertakes to close a transaction, contrasted with the very few tasks imposed on a seller to close, the time-essence clause "stacks the odds" of losing a transaction against the buyer, even though the buyer and all the third parties involved on their behalf may have acted with diligence at all times.

Further, for a vast majority of agents who work diligently to clear conditions and close a transaction, the time-essence clause places a **risk of cancellation** on a transaction which is not helpful. Foreseeable delays in closing a transaction exist in all real estate sales. Worse yet, the time-essence clause has, over the years, consistently demonstrated an ability to **produce litigation** over rights to money or ownership which have been lost or forfeited by a cancellation that is typically initiated by the seller.

*Editor's note — **first tuesday** purchase agreement forms do not contain a time-essence clause. Instead, the purchase agreements authorize agents to extend performance dates by up to one month. [See **first tuesday** Form 150 §10.2]*

Purpose of the time-essence provision

The "common understanding" said to exist as the purpose for including a time-essence clause in a purchase agreement is to **protect the seller from delays** in the buyer's payment of the sales price. Delays "tie up" both the seller's ownership of the real estate and receipt of the net sales proceeds beyond the date or period fixed for the transfer of ownership.

Another less logical theory for enforcing appointed dates as deadlines for the occurrence of events or the approval of the conditions called for in agreements containing a time-essence clause is the purported inability of courts to estimate the compensation owed a seller for losses resulting from a delay in the close of escrow due to the buyer's failure to perform.

However, delays in closing of a few days or even a few weeks or more, while inconvenient, rarely cause any compensable loss of money, property value, rights or property for the person attempting to cancel due to the passing of a performance deadline. Typically, the cancellation by a seller is motivated not by time, but by greater profits to be had elsewhere, i.e., "money is of the essence."

Even if a money loss is incurred due to a delay in performance, the loss is usually sustained by the seller and is easily calculable. Seller losses typically consist of lost rental value (or carrying costs) for the period beyond the appointed closing date to the actual date of closing. An infrequent exception which occurs and causes the seller an incalculable (and uncollectible) loss arises out of the seller's actions in different transactions, such as the seller's reliance on the closing of a sale (not his entry into the sale) to complete some other transaction.

As for the buyer, his losses on a seller's default usually arise out of a missed closing deadline which he needed to meet in order to receive tax benefits or a locked-in (low) interest rate loan.

Termination of rights

An effective **Notice of Cancellation** interferes with the completion of a transaction as initially envisioned by the buyer and seller at the time they entered into the purchase agreement and escrow instructions. On a proper cancellation, the person terminating the purchase agreement transaction **does not need to further perform** any act called for, including the close of escrow. Further, the transaction has been terminated and the obligations of both the buyer and seller to further perform no longer exist. [See **first tuesday** Form 183]

For example, the person who properly cancels a purchase agreement has the unfettered right:

- **in the case of a seller**, to retain ownership or resell the property to other buyers at a higher price; and
- **in the case of a buyer**, to keep his funds or use them to purchase other property on a better bargain.

These rights to act, free of purchase agreement and escrow obligations, are the very objectives met by canceling the purchase and escrow agreements. The alternative to canceling both agreements is an attempt to keep the transaction together by determining the additional time reasonably needed by the other person to perform as originally contemplated, and then granting an extension of time in which to do so. Should the "grace period" of additional time be granted, and then expire without compliance, a cancellation for failure to then perform is most understandable by all involved, and enforceable. [**Fowler** v. **Ross** (1983) 142 CA3d 472]

Still, an effective cancellation by one person *forfeits the rights* held by the other to close the transaction and receive the benefits bargained for on entering into the purchase agreement. Further, on an effective cancellation, the agents, escrow, lender and title company are all adversely affected by the cancellation's ripple effects since they all lose the time and effort they invested to get the transaction closed.

For example, when a seller cancels, the buyer loses, by *forfeiture*, his contract right to become the owner of the property. Conversely, if the buyer cancels, the seller loses the right to receive funds and be relieved of the obligation of ownership. Thus, a cancellation by either the buyer or the seller, if proper and enforceable, is the "final moment" in the life of a purchase agreement and escrow. Cancellation spells the end to all expectations held by everyone directly or indirectly affiliated with the sale who would have benefitted by the closing of the transaction.

Editor's note — For simplicity's sake, the following discussion will mostly refer to the timing of a seller's cancellation. However, the discussion fully applies to a buyer's cancellation as well.

Cancellation factors

For a seller to successfully cancel an escrow based on the failure of an event to occur or a condition to be met, the purchase agreement or escrow instructions should contain:

- a clear description of the **event** which is to occur or the **condition** to be approved;
- an appointed **date** or expiration of a time period by which the event or approval described is to occur; and
- a written provision stating in clear and unmistakable wording, understandable to the buyer, that the seller has the **right to cancel** the transaction as the consequence of a failure of the event or the approval to occur by the appointed date.

If provisions in the purchase agreement or escrow instructions meet all of the above criteria, then the seller will **only be allowed to cancel if**:

- the seller has **performed all acts which must precede**, by agreement or necessity, the event or approval triggering the cancellation (in other words, the seller is not in default);
- the event or approval **fails to occur** by the appointed date; and
- the seller performs or **stands ready, willing and able to perform** all other acts necessary on the part of the seller to close the transaction on the appointed date for the failed event or approval.

The notice given by the existence of the time-essence provision advises the buyer that his performance of the event which is to occur or be brought about by the date scheduled is **critical to the continuation** of the purchase agreement and escrow instructions. Thus, the time-essence provision sets the buyer's reasonable expectations of the consequences of his failure to perform, i.e., the risk that the seller may cancel the transaction and the buyer's right to buy the property will be forfeit.

However, the consequences of the failure of the buyer to perform or for an approval or event to occur depend upon the type of **time- related provision** contained in the purchase agreement and escrow instructions. The different provisions which might be included are:

- a **time-essence** provision, which gives the seller the right to cancel should the event or approval of a condition called for not occur by an appointed date;
- a **seller-may-cancel** contingency provision, which authorizes the seller to cancel should the condition or event not occur, whether or not a time-essence clause exists;
- an **authorization-to-extend** provision, which grants the agents the power to extend performance dates up to 30 days (or other wording indicating an accommodation for delays), whether or not a time-essence clause or a seller-may-cancel clause exists [See **first tuesday** Form 150 §10.2]; and
- an **extension of time granted by the seller**, typically in supplemental escrow instructions, with wording imposing strict adherence to the new performance deadlines and authorizing the seller to cancel on expiration of the extension should the approval or event not be forthcoming.

There is also the possibility that the purchase agreements and escrow instructions will not have a time-essence, cancellation or performance-extension provision included in them at all.

Elements of a default

Before either a buyer or seller can effectively cancel a transaction, they must "place the other person in default." Thus, in order for a person to exercise the right to cancel, that person cannot also be in default themselves on the date scheduled for the other person's performance or the event to occur.

For the buyer or seller to place the other in default, three transactional facts must exist:

1. a **date crucial to the continuation** of the transaction must have passed;
2. the condition called for in the purchase agreement **did not occur** by the scheduled date; and
3. the person canceling must have **fully performed** all activities required of him in order for the other person to perform by the scheduled date, called *conditions precedent*, and have performed or **be ready, willing and able to perform**, at the time of cancellation, all activities he was obligated to perform in order to close escrow, called *conditions concurrent*.

Was the cancellation timely

The **setting of a time** for an act or event to occur does not, by itself, automatically allow a purchase agreement transaction to be terminated by one person when the appointed date has passed and the other person has not yet performed.

To permit a cancellation immediately following the expiration of the appointed time for performance, the purchase agreement or escrow instructions must clearly state it is the intention of both parties that the failure by one or the other person to perform by the appointed day will subject his contract rights to forfeiture.

Thus, clear cut wording throughout the purchase and escrow documents must consistently manifest an intent to **make time for performance crucial** to the continued existence of the transaction. If not so worded, the appointed date has insufficient significance to justify instant cancellation.

For example, sometimes the only wording regarding any right to cancel a transaction appears in the escrow instructions. Escrows are nearly always instructed to close at any time after the date scheduled for closing if escrow is in a position to do so, provided escrow has not yet received instructions to cancel escrow and return documents and funds.

Thus, in this example, neither the purchase agreement nor the escrow instructions contain a clause stating "time is of the essence in this agreement." Further, no clear, unequivocal or unmistakable wording in any contingency provision shows an intent on the part of the buyer and seller to make time of the essence, such as wording giving the seller or buyer the "right to cancel" on the failure of either the other person to perform a described activity or for an event to occur by a scheduled date.

Under these examples, which lack time-essence provisions, the time appointed for the delivery of such items as loan commitments, termite reports, funds for closing or clearance of encumbrances from title is merely a "target date" **preliminary to establishing the right to cancel**.

To **establish** the right to cancel when time is not stated or established in the purchase agreement or escrow instructions as crucial, the person in default must be given notice that the date set as the "new deadline" will be **strictly adhered to**. Further, the person in default must be given a realistic opportunity (period of time) after being given a notice to perform before any cancellation would be effective. Continued nonperformance past the new deadline date will be treated as a **default** and escrow can be immediately canceled.

For example, a purchase agreement calls for a buyer to close escrow within 45 days after acceptance. No time-essence clause, cancellation provisions (other than the *implied right* to cancel exercisable on a failure of the other person to perform) or agent authorization to extend performance dates exists.

The seller agrees with the buyer's request to extend the date of performance (closing) an additional 30 days during which the buyer is to complete his arrangements to close escrow. Two days after the

extension expires, the seller cancels the transaction.

Is the seller's cancellation of the transaction effective?

Yes! The 30-day extension was a **reasonable amount of time** for the buyer to perform before the seller *exercised* his right to cancel. A further unilateral extension of time is not needed for the cancellation to be reasonable and effective. [Fowler, *supra*]

Now, consider an example of strict compliance with performance dates as "deadlines," after which the purchase agreement and escrow can be terminated by cancellation for failure of the described activity or event to take place. The **purchase agreement** contains a simple time-essence clause. Authority is not granted to the agents to extend performance dates should the appointed date for performance prove to be an inadequate amount of time for either the buyer or seller to complete or bring about all of their closing activities.

Consistent with the time-essence clause in the purchase agreement, **escrow instructions** provide for an interference with closing of the escrow after the date initially targeted for closing. The instructions authorized escrow to close at anytime after expiration of the escrow period, unless escrow received instructions calling for the return of documents and funds.

One day after the passing of the date scheduled for closing, the buyer cancels escrow. Twelve days later, the seller, using diligence at all times, is able to clear title and close. The seller challenges the buyer's cancellation as premature and ineffective, claiming the buyer is required to grant him the additional time needed to close escrow before the buyer can *forfeit the seller's right* to enforce the buyer's promise to purchase the property.

Is the seller entitled to the additional time he needs to close escrow?

No! The seller was **on notice** by the existence of the time-essence clause in the purchase agreement and the wording of the escrow instructions that the buyer had the right to cancel on failure of escrow to close by the date scheduled. No provision in any document expressed an intent which was contrary to the time-essence provision in the purchase agreement.

Thus, the buyer's cancellation, one day after the appointed closing date, was in accordance with the **intent stated** in the purchase agreement and escrow instructions, i.e., that timely performance was essential to the continuation of the agreement, and that escrow was authorized to return the money and instruments on the demand of either the buyer or seller should the closing not occur on or before the date set for closing. Thus, the buyer was not required to grant the additional time reasonably necessary for the seller to close the transaction. [**Ward** v. **Downey** (1950) 95 CA2d 680]

Intent in conflict with time-essence clause

Consider a sale under a purchase agreement (or escrow instructions) which contains a provision **authorizing the agents to extend** the time for performance of any act for a "period not to exceed one month." The purchase agreement also includes a boilerplate provision that "time is the essence of this agreement." Escrow is for a 60-day period, the end of which is the appointed date for closing the transaction. As usual, the escrow instructions state escrow may close at any time after the date scheduled for closing, unless instructions to the contrary have been received.

On the date scheduled for closing, escrow is not in a position to close due to the buyer's inability to immediately record his purchase-assist loan. The seller immediately cancels escrow in an attempt to terminate the transaction, claiming time was of the essence by agreement.

Can the seller cancel without giving an extension of time when both a time-essence and an authority-to-extend provision exist?

No! The bargain struck by the conflicting provisions controlling performance dates did not contemplate time for the occurrence of activities or events by their appointed dates to be so essential that the transaction could be canceled on the mere passing of the appointed date. The use of a purchase agreement (or escrow instructions) containing wording that "time is of the essence" does not allow for the forfeiture of contract rights on a failure to perform within the agreed time period when **other provisions exist expressing an intent contrary** to the time-essence provision.

When logically possible, courts ignore boilerplate time-essence clauses and enforce the original bargain, if no financial harm results from the delay.

Here, the purchase agreement (or escrow instructions) gave the agents the unconditional right to extend performance dates. Thus, being able to close by the date set for closing escrow could hardly be considered crucial to the continued viability of the transaction. Accordingly, the seller must give the buyer a **reasonable amount of time** to close escrow, i.e., the additional days needed for the agent to record the buyer's loan, before the buyer's failure to perform justified exercising any cancellation rights.

Editor's note — The fact the agents do not exercise the authority granted them to extend the time for performance is of no concern. It is the mere existence of the agents' unrestricted right to extend performance dates by up to 30 days which requires the person canceling to allow the other person a reasonable, additional time period in which to perform before cancellation can occur.

Default needed to justify cancellation

Before a buyer or seller may consider canceling a transaction, the other person must have *defaulted* on his completion of an activity or an event has failed to occur.

For example, a seller cancels a 30-day escrow the day after the date it is scheduled to close. The purchase agreement granted the agents authorization to extend performance dates, including the date for closing, up to 30 days. [See **first tuesday** Form 150 §10.2]

Thirty-three days later, for a total of 63 days from the date of acceptance, the buyer, using diligence in the pursuit of a loan, obtains final loan approval and has all the funds needed to close escrow.

Is the seller's cancellation effective without first giving an extension of additional time for closing when the buyer has not performed by the date scheduled for the close of escrow?

No! The buyer is not yet in default. Sixty-three days is a reasonable period of time for the buyer to obtain the purchase-assist mortgage funds agreed to in the purchase agreement. Most importantly for the buyer and agents, time for closing was not made crucial to the continuation of the agreement. Thus, a reasonable period of time must pass before the buyer is in default. Only when the buyer is in default may the seller *exercise* his right to cancel. [**Henry** v. **Sharma** (1984) 154 CA3d 665]

Now, consider an agent who prepares a purchase agreement and inadvertently fails to set a fixed time period for the opening of escrow. However, the purchase agreement does state an appointed date for closing escrow as 60 days from the date the purchase agreement was entered into.

The buyer fails to sign and return escrow instructions to open escrow.

The seller cancels the transaction 12 days after the date escrow was scheduled to close.

Was the buyer in default at the time of cancellation?

Yes! The buyer was in default for his failure to sign and return escrow instructions. The buyer had an obligation to open escrow within an unstated period of time. Since the time for opening escrow was not agreed to, a **reasonable period of time** for opening escrow is allowed.

A reasonable period for opening escrow is a date sufficiently in advance of the date set for the close of escrow to give escrow enough time to perform its tasks by the date scheduled for closing. The cancellation 12 days after the closing date was effective to terminate the transaction since a reasonable period for the buyer to open escrow ended well before the scheduled closing date. The buyer, having failed to open escrow before the closing date, was in default on the closing date. Thus, the buyer lost his right to buy the property since he did not cure the default by opening escrow before the seller canceled. [**Consolidated World Investments, Inc.** v. **Lido Preferred Ltd.** (1992) 9 CA4th 373]

However, a one day delay by a buyer before signing and delivering instructions to open escrow does not allow a (remorseful) seller to cancel the transaction and avoid closing escrow. Reasonably, a **one day delay in opening escrow** is not a default at all, even when time is unequivocally declared to be of the essence in the purchase agreement.

To cancel you must first perform

Consider a seller who wants to cancel a transaction since the buyer is in default under the purchase agreement or escrow instructions. Before the seller may cancel, the seller must:

- perform all acts and cause all events to occur which, by agreement or necessity, are the seller's obligation and **must occur before** the buyer becomes obligated to perform or can perform, called *conditions precedent*, such as delivering disclosures, reports, etc., or completing repairs requiring the buyer's approval;
- fully perform all activities and obligations imposed on the seller which are to **occur at the same time** as the buyer's performance, without concern for whether the buyer has performed, called *conditions concurrent*, such as handing escrow a grant deed and all other information and items required of the seller for escrow to clear title and close; and
- perform or **demonstrate he can perform** all other activities or bring about events which are the obligation of the seller for closing the transaction, whether or not the buyer ever performs, called *conditions subsequent*, such as meeting any requirements of the buyer's lender for repairs or clearances.

Thus, while the buyer may have failed to perform by the time agreed, the seller may not cancel until the seller has performed or stands ready, willing and able to perform under the above three conditions (precedent, concurrent and subsequent), conditions which exist in most purchase agreements and escrow instructions.

When failure to fund is not a default

On the date set for the close of escrow, buyers often have not deposited their down payment funds into escrow as called for in the purchase agreement and escrow instructions. When the deposit of closing funds or the lender's wire of loan funds does not occur as scheduled, the buyer clearly has not yet performed his obligation to close escrow. However, the failure to fund does not necessarily mean the buyer is in default.

The question which arises for a seller who is attempting to cancel when time has been established as essential and the buyer or the buyer's lender has not delivered closing funds, is whether the buyer is either in **default** or is **not yet obligated** to deposit funds.

Escrow, as a matter of custom, will not call for a wire of closing funds from the mortgage lender or the buyer until **escrow is in a position to close**. Escrows, as an entirely practical matter, do not want closing funds sitting in an escrow which is not yet ready to close.

Specifically, before escrow calls for closing funds, the seller must have already fully performed by providing documents (deeds, releases, reconveyances, title clearances, etc.) so the conveyance of title can be insured and property clearances, prorates and adjustments can be delivered and accounted for as called for in the escrow instructions. If the seller has not delivered instruments so escrow can be in a position to close by the date scheduled for closing, escrow will not make a demand on the buyer (or lender) for funds. The deposit of closing funds would be premature since escrow cannot yet close.

Further, when the closing is contingent on the buyer recording a purchase-assist loan, escrow, as a matter of *commercial necessity*, does not call for the buyer's funds until the lender is ready to fund.

Thus, the buyer has no obligation to deposit any money into escrow and is not in default until escrow has received the lender's documents and requests the buyer's funds, which the buyer **then fails to deliver**. Until the buyer is in default due to a failure to timely respond to escrow's request for funds, any attempt by the seller to cancel is premature and ineffective.

Escrow instructions usually state the buyer is to deposit funds for use by escrow **provided the seller has performed**. Thus, the obligation of the buyer to deposit closing funds is subject to the seller first performing, called a *condition precedent* to the buyer's performance. Therefore, the buyer's "failure" to deposit funds before escrow is in a position to close is *excused*. The seller has failed to hand escrow documents and information sufficiently in advance of the scheduled closing date for escrow to close by the appointed date.

Consider a seller who is unable to convey title to a buyer and deliver a title insurance policy by the closing date called for in the purchase agreement and escrow instructions. The title company cannot issue a policy as ordered due to encumbrances affecting title, such as abstracts, trust deeds, leases, tax liens, assessments, etc., which have not been released and the amounts needed for discharge and payoff have not yet been determined.

Here, the time for closing has arrived and the seller cannot deliver a marketable title as agreed. Thus, until the seller obtains title insurance for his deed, the buyer is not in default for not yet depositing his funds.

Cancellation right waived by conduct

Even when the date scheduled for a buyer or seller to perform is established as crucial, thus allowing one person to immediately cancel on the other's default, **inconsistent conduct** by the person entitled to cancel constitutes a *waiver* of his right to cancel. Once the right to immediately cancel has been waived, the person who failed to perform by the agreed deadline is **no longer in default**. Until the person who failed to perform is placed in default again, the right to cancel cannot be exercised.

For example, the date set for escrow to close arrives. The seller has not yet handed escrow (or the buyer) clearances which are required before escrow may close.

A few days after escrow is scheduled to close, the seller deposits the clearances with escrow. The buyer then deposits his closing funds on a call from escrow.

Two days later, the seller cancels escrow, claiming the buyer was in default since he failed to deposit his funds by the appointed date.

Here, the cancellation is ineffective and the buyer is entitled to close escrow. The seller *waived his right* to cancel, time having been of the essence, by conducting himself without concern for the passing of the appointed date for closing. The seller failed to deliver up documents or information sufficiently in advance for escrow to meet the deadline. [**Katemis** v. **Westerlind** (1953) 120 CA2d 537]

However, a **waiver by inaction** does not occur simply because a person's right to cancel the transaction is not immediately exercised on the failure of the other person to perform or an event to occur. **Affirmative conduct must occur** by the person entitled to cancel, not just mere inaction, before the right to cancel under a time-essence situation is waived.

After a waiver of a date scheduled for approval of a condition or occurrence of an event, time must be **reinstated as crucial** to the continuance of the transaction, or a reasonable, additional period of time must have passed after waiver of the right to cancel, before the transaction can be canceled.

Time is best reinstated as essential to the continuation of the transaction by notifying the person who needs to perform that he must perform by the end of an additional period of time, set with sufficient duration as is needed to provide him with a realistic opportunity to perform.

If performance is not forthcoming during the additional period of time, the transaction may be promptly canceled since *strict compliance* with the extension is now enforceable.

Chapter 16 Real estate purchase options

This chapter discusses the legal affects of option agreements and their use in real estate sales.

An irrevocable offer to sell

A real estate syndicator searching for investment-grade, income-producing real estate locates a property which appears to be financially suitable for a group investment, called *syndication*.

However, the syndicator will not commit himself to the purchase of the property until he has **fully investigated** the condition of the improvements, the property's operations and the availability of financing, an effort called *due diligence*.

Further, on completing his due diligence investigation, and if conditions are found to be acceptable, the syndicator will need additional time to prepare an **investment memorandum** and to **locate investors**. The memo will contain his narrative report on the significant information he has gathered concerning the worth of the property. The report will be circulated among equity investors as a solicitation to form a group to fund the acquisition of the property.

First, before the syndicator begins his in-depth analysis of the property, he needs to enter into an enforceable purchase agreement with the seller. Without an agreement to acquire the property, the property may be sold to someone else before he can complete his investigation and determine the property is suitable for acquisition.

To acquire the right to buy the property without unconditionally committing himself to purchase the property, the syndicator submits an offer which calls for the occurrence of several events before he becomes committed to the purchase of the property in provisions called contingency provisions.

The contingency provisions include approval of the property's physical condition, its leasing income and operating expenses, available mortgage financing, title and zoning restrictions on use, and the existence of equity investors to fund the closing.

The seller fully understands the contingencies are designed primarily to enable the syndicator to confirm his understanding of the property's condition as represented by the seller and to obtain the mortgage and equity financing needed to fund the close of escrow. However, the seller is concerned the syndicator's inability to satisfy and remove the contingencies could interfere with the seller's ability to promptly cancel the agreement should the syndicator fail to close or cancel the transaction by the date scheduled for closing.

The seller decides not to accept the syndicator's purchase offer due to uncertainty regarding the syndicator's timely performance.

However, the seller is willing to grant the syndicator an **option to buy** the property at the same price and for the same time period sought by the syndicator in his offer to purchase. Thus, the seller counters the offer.

Here, a counteroffer form will not be used to respond to the syndicator's offer. A counteroffer would incorporate the terms of the syndicator's purchase offer, subject to any modifications stated in the counteroffer.

In this situation, the seller simply prepares and hands the syndicator an **offer to grant an option**, which is attached to the seller's offer. Thus, the seller *rejects* the syndicator's offer in its entirety. [See **first tuesday** Form 160]

The seller's offer to grant an option requires the syndicator to accept the offer and the terms of the proposed option agreement before the seller is bound to deliver the signed option agreement. To accept the seller's offer to grant an option, the syndicator must sign the acceptance provision in the offer and return it to the seller. Of course, the acceptance must occur before expiration of the seller's offer to grant the option.

For the syndicator, his purchase of an option to buy property imposes no obligation on him to open escrow and purchase the property. Unlike a real estate purchase agreement, the buyer holding an option to buy has **no obligation to purchase** the property.

Conversely, the option contains the seller's irrevocable offer which **obligates the seller to sell** the property on the terms stated in the option agreement should the syndicator decide to buy the property within a set period of time, called the *option period*. The syndicator only agrees to buy the property when he **timely accepts** the seller's irrevocable offer to sell, an acceptance called *exercising the option*.

In exchange for the seller granting an option on the property, the syndicator will pay the seller *option money*. The amount of option money is the price the syndicator pays to **buy the option** and "tie up" the property by removing it from the market. [See **first tuesday** Form 160]

Thus, the option agreement allows the syndicator to control the property without committing himself to purchase it until he exercises the option, if ever. His completion of the property analysis and solicitation of investors will indicate whether he will exercise the option or not.

However, when the syndicator exercises the option, a *bilateral sales contract* is automatically formed, no differently than had he accepted an offer from the seller to sell the property under a purchase agreement containing nearly identical terms. Thus, on exercise, both parties become obligated to perform as agreed and must proceed with closing the sale since no contingencies exist. [**Caras** v. **Parker** (1957) 149 CA2d 621]

Should the syndicator let the option period expire without exercising the option, the seller will be able to sell the property to another buyer, unaffected by the option since the seller's irrevocable offer to sell represented by the option has expired.

In an option agreement, the owner is referred to as the *optionor* and the potential buyer is referred to as the *optionee*. They become the seller and buyer, respectively, on exercise of the option.

Editor's note — An option granted to a buyer is to be distinguished from an exclusive right-to-sell listing granted to a broker. On entering into a listing, the seller incurs no obligation to sell the property to anyone. The owner has only employed the broker as his agent to find a buyer and represent the seller in negotiations. The broker has not received power-of-attorney authority to commit the seller to a sale of the property and the listing is not an offer to sell anything.

Benefits for opposing positions

An option agreement provides benefits for both buyer and seller.

A **buyer** should consider acquiring an option when:

- he does not yet want to commit himself to buy;
- he is speculating in a depressed market that values will soon rise;
- he needs time to investigate and determine whether the property will operate profitably;
- he needs time to do promotional work such as syndicating, subdividing, rezoning, obtaining permits or loan commitments, or to complete a §1031 reinvestment; or
- he is a tenant and may want to own the leased premises some day.

A **seller** should consider granting an option when:

- he wants to retain ownership rights to the property for a fixed period into the future (for tax purposes);
- he wants to sell at a price based on higher future market values;
- he needs to provide an incentive to induce a prospective tenant to lease the property; or
- he wants to give a promoter incentive to work up a marketing or use plan and buy the property.

Multiple option periods

Developers require a longer initial option period, or the right to extend the option period, to provide time in which to study a property, obtain government clearances and locate financing for development. If these objectives are met, the developer will be able to purchase the property on a previously agreed set of terms.

Thus, it is foreseeable a developer may need **additional time** beyond the initial option period to complete his due diligence and approval process before committing himself to the purchase of the "optioned" property. Here, the option agreement should include the right to buy one or more extensions of the option period on the payment of additional option money before the expiration of the preceding option period.

The developer who determines he will be unable to develop or to successfully market a development of the property will simply not exercise the option.

Lease with option

The other significant use of an option to buy relates to residential and nonresidential leasing arrangements. Prospective tenants might want the ability to later acquire ownership of the property they will be occupying.

Tenants often need to invest substantial dollar amounts in tenant improvements to tailor the property to the tenant's needs. Whether contracted for by the tenant or the landlord, the tenant pays for the improvements either by a lump sum, upfront expenditure or by payments amortized over the initial life of the lease as part of the monthly rent.

Also, installation of racks, cabinets, shelving, trade fixtures, lighting and other interior improvements will be needed to make the premises fully compatible for the tenant's occupancy. These too will be paid for by the tenant. Always, a degree of "goodwill" is built up with customers due to the location of the business on the property. Thus, the location becomes part of the value of the tenant's business so long as he remains at the location.

All these opportunities will be lost if the landlord refuses to extend the lease or his demands for increased rent under an option to extend the lease compels the tenant to relocate. A tenant with even a small degree of insight into his future operations at the location will attempt to negotiate some sort of option to purchase the property. At least an option to renew at lesser rental rates should be negotiated, as the tenant improvements (TIs) have been paid for by the tenant and the landlord has fully recovered any costs he may have incurred.

A lease with an option to purchase must be distinguished from the purchase rights held by a tenant under a right of first refusal agreement or a buyer under a lease-option sales arrangement.

Need for consideration

An option agreement is not enforceable unless a seller receives some sort of consideration. Unless the seller is given something in exchange for the right he has *surrendered* to revoke his offer to sell or to sell the property to others, the option fails for *lack of consideration*. Without the payment of consideration, the agreement is merely an offer to sell which may be **withdrawn at any time** by the seller. [**Kowal** v. **Day** (1971) 20 CA3d 720]

While consideration is needed to create an option agreement which is binding on the seller, the amount of the consideration paid for an option may be a minimal amount. An enforceable option can be created for as little as 25 cents paid by a buyer.

Also, the consideration given for the option does not need to be in cash. For instance, when an option to purchase is granted to a tenant who enters into a lease, the consideration given for the grant of the option rights is the tenant's signature obligating the tenant to perform on the lease.

In the case of a syndicator or developer using an option to control property he is not yet certain he wants to purchase, the consideration is the option money paid to the seller to grant the irrevocable offer to sell. The option money is typically set at an amount which will compensate the seller for the time the property is kept off the market, similar to a payment of rent or interest (less any actual and implicit income produced for the owner by the property).

Often a small amount of option money is paid for a short initial option period, sometimes called a "free-look" period. The term of the free-look option may be twenty to thirty days, granted on the payment of a small amount of option money, such as $100.

If the buyer is given extensions to continue the option after the free-look period, he usually is required to put up a more substantial amount of option money.

Any number of additional option periods may be agreed to, one following the expiration of another. The number of extensions depends only on the seller's willingness to grant the extensions and the buyer's willingness to put up more option money to pay for those extensions.

Exercising the option

Unless a particular manner for exercising the option is specified in the option agreement, any communication from a buyer to a seller of his intention to exercise the option is sufficient. [**Riverside Fence Co.** v. **Novak** (1969) 273 CA2d 656]

However, if the option agreement requires the buyer to take specific steps to exercise the option, the buyer must follow the conditions set in order to exercise the option and acquire the property. [**Palo Alto Town & Country Village, Inc.** v. **BBTC Company** (1974) 11 C3d 494]

Not an option

A **right of first refusal**, often held by a tenant in connection with a lease agreement, resembles an option. However, a right of first refusal does no commit the owner to sell the property to the tenant.

Instead, a right of first refusal agreement merely grants the tenant the first opportunity to purchase the property if the owner later decides to sell. Until the owner **decides to sell**, the tenant has no enforceable right to purchase the property.

A **lease-option sale,** in contrast to a true purchase option held by a tenant, is neither a lease nor an option. Carryback sales are sometimes structured and recharacterized as leases with purchase options.

The installment sales agreement is called a lease, the buyer is called a tenant, the down payment is called option money, and the monthly payments, part of which are credited to the principal, are called rent. However, the lease-option is actually a completed credit sale of the property.

The lease-option buyer, on occupying the property, becomes the equitable owner, and the seller has converted his ownership interest on title to the position of a secured creditor under an installment sale, called a **land sales contract**.

Determining the distinction between a true lease with an option to purchase and a carryback sale structured as a lease option sale requires an examination of the **economic realities** of the transaction.

For instance, if the agreement calls for all or part of the option money, or each month's "rent" payment, to be credited toward the purchase price or down payment, the "lease with option" is most likely an improperly documented credit sale by a carryback seller.

Other clues include "rent" payments which substantially exceed the property's fair market rental value, and purchase price which has been set at a fixed dollar amount.

A genuine lease with an option to purchase usually does not include a set purchase price at the fair market value of the property at the time the tenant exercises the option, with no credit of rent payments or option money to the purchase price.

For instance, an option agreement should require a buyer to sign escrow instructions and deposit cash in escrow to exercise the option. If the instructions are not signed, or if signed and the deposit is not made, the option has not been exercised. Thus, the buyer has not exercised his right to acquire the property.

Proposed escrow instructions should be prepared and attached as an addendum to the option agreement to avoid any conflict over the content of the instructions required to be entered into to exercise the option. The instructions will remain unnumbered, undated and unsigned until exercise of the option. [See **first tuesday** Form 401]

The escrow opened to exercise an option should call for escrow to close within a short period of time, i.e., the number of days required to prepare documents, order title reports and close. Unless an option agreement requires the buyer to sign escrow instructions, deposit funds and close escrow within a short period of time, the buyer's exercise of the option merely creates an enforceable bilateral purchase agreement with no escrow, funds or clear closing date.

Recording the option

When a purchase option or memorandum of the option is recorded, it becomes part of the property's chain of title, imparting *constructive notice* of the outstanding option rights to anyone later obtaining an interest in the property. A buyer, lender or tenant acquiring an interest in the property with **actual or constructive notice** of the existence of an option to purchase the property takes his interest in the property **subject to** the buyer's option rights.

Conversely, a buyer, lender or tenant who does not have actual knowledge of an unrecorded and unexpired option, takes his interest in the property **free of** the option.

For example, a seller grants a buyer an option to purchase property. Before the option is recorded or the buyer takes possession, the seller conveys the property to a second buyer. The second buyer did not have actual knowledge of the first buyer's option on the property.

The buyer who was granted the option later exercises the option by depositing the full amount of the purchase price into an escrow he has opened as agreed in the option agreement.

However, the seller who granted the option is no longer the owner of the property. Thus, he has no interest in the property to convey. Also, the option agreement is not enforceable against the second buyer since the second buyer, who is now the owner of the property, had no knowledge of the first buyer's option when he acquired ownership.

Thus, the conveyance of the property to the second buyer without notice of the unexpired option wiped out the first buyer's right to buy the property under the option. [**Utley** v. **Smith** (1955) 134 CA2d 448]

A recorded option **ceases to constitute constructive notice** of a buyer's option rights when:

- six months have run after the expiration date stated in the recorded option agreement or memorandum without the prior recording of an *exercise* or *extension* of the option; or
- six months have run after the option or memorandum was recorded should the expiration date not be stated in the recorded option agreement or memorandum. [Calif. Civil Code §884.010]

The purpose for the extinguishment of the recorded option from title is to protect buyers and sellers of property from old, unexercised and expired option rights which are of record. No such statutory scheme exists for the "outlawing" of unrecorded options which have expired.

Chapter 17 — The right of first refusal

This chapter presents a right of first refusal provision, distinguishing it from a purchase option and contingency waiver provision.

A buyer's preemptive right to purchase

A buyer is interested in purchasing a parcel of real estate. The seller also owns an adjacent parcel, which the buyer is also interested in purchasing. The seller, however, is not willing to sell the adjacent parcel.

The buyer's offer to purchase one parcel provides for the seller to grant an **option to purchase** the adjacent parcel. The option to purchase gives the buyer an unconditional right to later buy the adjacent parcel at his discretion. Should the seller accept the offer, he will have no choice but to sell the adjacent property if the buyer decides to purchase the first parcel.

The seller is unwilling to leave the timing of the sale in the buyer's control, or to set a certain date for exercise of a purchase option.

The seller counteroffers to grant the buyer a **right of first refusal** for a five-year period, also called a *preemptive right* to purchase. Should the seller decide to sell the adjacent parcel during the period of the right of first refusal, the buyer can then acquire the property.

If the seller decides to sell the adjacent property within the right of first refusal period, the buyer will be notified of the price and terms of sale. Most commonly, the terms set for the sale are the terms of another buyer's offer which the seller is willing to accept. The buyer, to exercise the right of first refusal, must then match the other buyer's offer.

The price and terms may also be agreed to as the property's fair market value, as set by a court decision, such as a court-ordered probate sale, or simply by the seller deciding the price and terms acceptable to him.

Editor's note — When granting a right of first refusal, the seller must be careful not to set the price in advance. If a fixed price is set in the right of first refusal agreement, the seller is bound to that price should he later decide to sell. If the property is sold to another buyer at a higher price in violation of the first refusal right, the seller must pay the difference to the holder of the right of first refusal. [**Mercer** v. **Lemmens** (1964) 230 CA2d 167]

Refusal vs. option

The right of first refusal is different from an option agreement. In an option, the owner agrees to sell the property on specific terms. The buyer has the **discretionary** right to buy or not to buy the property on those terms within the time period fixed for the exercise of the option. The decision to buy the property by exercising the option rests solely with the buyer.

In a right of first refusal agreement, the decision to sell or not to sell is entirely within the **seller's discretion**. Until the seller makes the decision to sell, the buyer has no right to purchase the property.

Once triggered by the seller's decision to sell, the first refusal right results in a purchase option — no different from any other purchase option. The buyer has an unconditional right to buy or not to buy the property within a fixed period of time, called an *acceptance* or *exercise* of the right of first refusal.

Seller's motives

The seller's reasons for granting the buyer a right of first refusal may vary. Possible **motives** for delaying the decision to sell the real estate include:

- **tax benefits**, such as wishing to delay the reporting of profit from a sale until a year when the profit can be offset by losses on the sale or operation of other properties;
- **financial incentives**, such as wanting to delay the sale of the property to attain the highest price possible due to a rising market, leasing negotiations, rehab, or rezoning;
- **legal problems**, such as a lis pendens or toxic cleanup hindering the sale of the property; and
- **personal concerns**, such as not being ready to sell the property for health or family reasons.

Finally, the owner may simply have no intention to ever sell the property. In such a case, the buyer might request a right of first refusal on the theory the owner may someday change his mind.

Ultimately, the right of first refusal serves the same purpose for the seller as an option serves for the buyer — to avoid entering into an enforceable commitment to sell or buy real estate.

Buyer's commitment

A buyer wants to purchase the best property available at the best price. Ideally, a buyer would acquire purchase options on numerous properties, then watch the market and purchase only the most desirable of the optioned properties.

However, buyers should not play the option game too loosely. Creating an enforceable option or right of first refusal agreement requires a mutual obligation. Each party must commit himself in some way before he can enforce the agreement against the other. [**Kowal** v. **Day** (1971) 20 CA3d 720]

Forms of **commitment** include giving up a legal right, assuming a legal obligation, a promise to pay, or payment of a **consideration** to the other party (though it may only be a small amount).

The seller commits himself by granting the buyer the right of first refusal in a signed writing. To bind the seller's promise to sell and make the right of first refusal enforceable against the seller, the buyer must make a commitment in return.

For instance, the person who negotiates a right of first refusal typically has some involvement with the property, such as occupying it as a tenant or buying other property owned by the seller. Otherwise, a buyer would have little incentive to pay for a right which may never ripen into a right to buy.

If the right of first refusal is negotiated simultaneously with a lease or purchase agreement, consideration for the right is simply the promise to pay rent and perform under the lease, or the purchase of other property owned by the seller. The right is simply one of the provisions of the agreement.

If a right of first refusal is added to an existing lease, or granted to the buyer of an adjacent property after the lease or purchase has been agreed to, some additional consideration must be negotiated and paid to the seller.

Triggering the right

The seller need not enter into an actual purchase agreement to trigger the tenant's right of first refusal. Any indication that the seller has decided to sell the property is sufficient to activate the right to buy.

The seller may indicate his decision to sell by:

- offering the property to the buyer;
- offering the property to another buyer or accepting an offer from or making a counteroffer to another buyer;
- listing the property for sale; or
- granting a purchase option on the property to a third party.

For example, a buyer with knowledge of an outstanding right of first refusal tries to avoid the first refusal right by negotiating an option to buy the property which is exercisable only after the right of first refusal expires.

The seller grants the option to purchase the property to the buyer. The granting of the option now binds the seller unconditionally to sell the property, should the option be exercised.

The seller's willingness to enter into the option agreement is a clear indication of a decision to sell. Thus, the right of first refusal is triggered. [**Rollins** v. **Stokes** (1981) 123 CA3d 701]

The right of first refusal is not triggered by the conveyance of the property to the seller's heirs on the seller's death. The heirs simply take title subject to the first refusal right.

However, the right of first refusal is triggered by the probate court's order of a sale of the property. To exercise the first refusal right, the buyer must match the highest offer submitted in open bidding and approved by the court. [**Estate of Patterson** (1980) 108 CA3d 197]

Once the seller's decision to sell is manifested, the right of first refusal becomes a purchase option. Control of the transaction thus passes to the holder of the first refusal right who is now an optionee.

The seller may no longer delay or retract the sale of the property — colorfully referred to as an attempt to "un-ring the bell" — without breaching the right of first refusal agreement.

Matching the back-up offer

Most of the disputes concerning the right of first refusal arise when the seller accepts another buyer's offer to purchase. If another buyer makes an offer on the property which the owner accepts or counteroffers, the owner must notify the holder of the first refusal right of the terms of the sale.

The holder of the preemptive right must then either agree to match the back-up offer within the fixed period of time or waive the right of first refusal.

For example, a buyer offers to exchange a property he owns for a property that is subject to a tenant's right of first refusal. The seller notifies the tenant and gives him the right to match the buyer's offer. The tenant obviously is not able to offer the seller the same property in exchange, nor is he expected to.

The tenant's offer under the right of first refusal need not be identical in all aspects to the other buyer's offer. To match the back-up offer, the tenant must merely provide the same net financial result to the seller. [**C. Robert Nattress & Associates** v. **CIDCO** (1986) 184 CA3d 55]

In another example, a tenant holds a right of first refusal. Another buyer offers to purchase the property with a cash down payment and a note secured by property other than the real estate being purchased. The seller accepts the offer and notifies the tenant of his right to match the offer.

The tenant offers to pay the same amount as the other buyer, also in the form of a cash down payment and a note secured by other property. However, the seller refuses to perform because the value of the property the tenant offers as security is insufficient.

The seller in this case is not obligated to accept the tenant's offer. Due to the inadequacy of the security offered for an identical note from the tenant, the tenant's offer is not **financially equivalent** to the terms of the other buyer's offer. [**McCulloch** v. **M & C Beauty Colleges** (1987) 194 CA3d 1338]

Lease rights remain

When a tenant's right of first refusal to buy property is not exercised, it is extinguished by a sale to another buyer.

However, the tenant may retain possession under the terms of the lease after the property is sold to another buyer. The sale is subject to the tenant's leasehold interest but not to his preemptive right. [**Manasse** v. **Ford** (1922) 58 CA 312]

Reinstatement of preemptive rights

The right of first refusal agreement should include a provision calling for the reinstatement of the right of first refusal when:

- the landlord sells to another buyer on different terms than those offered to the tenant; or
- the property remains unsold for a fixed period of time after the tenant waives the right. [See Figure 1]

Figure 1

Lease provision: Right of first refusal to buy

Landlord hereby grants tenant a right of first refusal to purchase the leased premises, for a term commencing _________________ and expiring ________________.

Should landlord decide to sell the premises during the term of the tenant's right of first refusal, landlord shall notify tenant of the terms on which landlord is willing to sell.

Tenant shall have the option for a period of ________ days after receiving notice to purchase premises on terms stated in notice.

Should tenant fail to exercise the option within the option period, landlord shall have the right to sell premises to a third party on the same terms stated in the notice to tenant. Any sale on different terms reinstates the right of first refusal.

If property is not sold within six (6) months after tenant's receipt of notice, the right of first refusal is reinstated.

Consider an owner under a right of first refusal who notifies his tenant of terms of sale he has agreed to with a buyer. The tenant chooses not to exercise his right of first refusal, since he finds the price and terms unacceptable.

The owner later modifies the terms of sale and closes the transaction.

However, the tenant's right of first refusal is reinstated, since the buyer purchased the property on terms other than the terms stated in the notice to the tenant. The tenant waived his right of first refusal based on the original terms in the notice given to him by the owner. Thus, the buyer now takes title subject to the tenant's preemptive right to purchase on the modified terms, since the buyer is aware of the existence of the tenant and is charged with knowledge of the right of first refusal.

The reinstatement clause simply reinforces the tenant's right to match any purchase offer the landlord is willing to accept.

The right of first refusal agreement also calls for reinstatement of the preemptive right should the owner not sell the property within a fixed time period after the buyer fails to exercise his right of first refusal.

Contingency waiver distinguished

The title "Right of first refusal" is sometimes incorrectly applied to **contingency waiver** clauses written into counteroffers. A contingency waiver provision is occasionally agreed to when a purchase agreement contains contingencies allowing the buyer to cancel.

For example, the closing of the sale may be conditioned on the buyer's sale of other property, or the buyer's obtaining a purchase loan.

The seller may be uncertain whether the buyer's contingencies will be met, and may want to be able to accept a back-up sale and eliminate the buyer's contingencies.

The seller always has the right to enter into back-up sale arrangements (which would be contingent on the cancellation of the existing purchase agreement with the buyer) while the property is in escrow.

However, for the seller to be able to close a back-up sale to another buyer, the first buyer must have agreed to a contingency waiver provision. Upon notice of a back-up sale, the buyer subject to a contingency waiver provision must **waive** the remaining contingencies within a given period of time, or the seller can **cancel** the transaction and proceed to close the back-up sale.

The contingency waiver clause is frequently misnamed a buyer's right of first refusal, since it shares a similar triangular structure of a buyer, a seller and another buyer's offer.

In essence, the buyer may **refuse to waive** his contingencies, thereby losing the property to another buyer should the seller cancel, or **waive the contingencies** and attempt to close the purchase escrow as agreed.

However, the contingency waiver provision differs from a right of first refusal since the obligation to perform and the terms of the sale transaction are already agreed upon, although subject to the seller's right to cancel should the buyer refuse to waive his contingencies on notice. Conversely, under a right of first refusal agreement, the seller has no obligation to sell until he decides to sell, and no purchase agreement exists.

In negotiating a contingency waiver clause, the seller has essentially secured a contingency for himself: to eliminate the buyer's contingencies or cancel the sale should a more acceptable sales arrangement be negotiated with a back-up buyer.

Chapter 18 An owner's residence in foreclosure

This chapter examines the equity purchase restrictions which must be known and applied by all investors buying owner-occupied, one-to-four unit residential property in foreclosure

The equity purchase sales scheme

An equity purchase (EP) transaction takes place when an owner-occupied, one-to-four unit residential property in foreclosure is acquired for rental, investment or dealer purposes by a buyer, who is called an *EP investor*. Conversely, an EP transaction does not occur and the EP rules do not apply if the buyer acquires the property for use as his personal residence.

Equity purchase statutes apply to all buyers who are EP investors regardless of the number of EP transactions the investor completes. The investor does not need to be in the business of buying homes in foreclosure for the statutes to apply to him. [**Segura** v. **McBride** (1992) 5 CA4th 1028]

Both the EP investor and his agent must comply with EP law or be subject to drastic penalties.

Also, all agents need to be aware that the EP agreement signed by an EP investor must be printed in **bold type**, ranging from at least 10-point to 14-point font size, and be in the **same language** used during negotiations with the seller-in-foreclosure. [Calif. Civil Code §§1695.2, 1695.3, 1695.5]

Thus, the EP investor and all the agents involved in the transaction must use a written agreement containing statutory EP notices. Failure to use the correct forms subjects the EP investor and the agents to liability for all losses incurred by the seller-in-foreclosure, plus harsh penalties. [Segura, *supra*]

*Editor's note — **first tuesday's** Equity Purchase Agreement, Form 156, complies with all statutory requirements and properly sets forth the right of the seller-in-foreclosure to cancel.*

Cancellation within five business days

Prior to closing a sale, a seller-in-foreclosure has a **statutory five-day right to cancel** the EP agreement he has entered into with an EP investor. Thus, the seller can avoid the sale entirely, with or without cause.

The EP investor's compliance with the requirement of a written purchase agreement incorporating the EP rules grants the EP seller the automatic five-day right to cancel the agreement before a closing can take place. If the seller cancels within the period, the sale under the purchase agreement cannot be closed.

When the notice of the seller-in-foreclosure's cancellation rights are properly contained in the EP agreement, the seller's **cancellation period ends** at:

- midnight (12:00 a.m.) of the **fifth business day** following the day the seller enters into any type of purchase agreement with an EP investor; or
- 8:00 a.m. of the day scheduled for the **trustee's sale**, if it is to occur first. [CC §1695.4(a)]

The seller-in-foreclosure's five-business-day right to cancel does not begin to run until proper notice of the cancellation period is given to the seller. [CC §1695.5]

The first and proper time for giving the seller-in-foreclosure the notice is in the EP agreement. Failure to do so allows the seller to *cancel* the sales agreement and escrow, even to *rescind* the sale after closing, until the notice is ultimately given and the five business days have run without cancellation.

A **business day** is any day except Sunday and the following business holidays: New Year's Day, Washington's Birthday, Memorial Day, Independence Day, Labor Day, Columbus Day, Veterans' Day, Thanksgiving Day and Christmas Day. Thus, Saturday is considered a business day under EP law, unless it falls on an enumerated holiday. Many state holidays are not included as holidays. [CC §1695.1(d)]

Until expiration of the right of the seller-in-foreclosure to cancel the transaction, the EP investor may not:

- **accept or induce a conveyance** of any interest in the property from the seller;
- **record any document** regarding the residence signed by the seller with the county recorder;
- transfer an interest in the property to a third party;
- **encumber any interest** in the residence; or
- **hand the seller** a "good-faith" deposit or other consideration. [CC §1695.6(b)]

However, escrow can be opened on acceptance, and deeds and funds deposited with escrow, since the seller-in-foreclosure is not delivering a conveyance (to the buyer) and will not receive funds until the close of escrow.

In negotiations with the seller-in-foreclosure, the EP investor, as with any buyer or agent, may not make false representations or misleading statements about:

- the value of the property in foreclosure;
- the net proceeds the seller will receive on closing escrow [See **first tuesday** Form 310];
- the terms of the purchase agreement or any other document the EP investor uses to induce the seller to sign; or
- the rights of the seller in the EP transaction. [CC §1695.6(d)]

Cancellation of the purchase agreement by the seller-in-foreclosure is **effective on delivery** of the signed written notice of cancellation to the EP investor's address in the purchase agreement. [CC §1695.4(b)]

When the EP investor receives the seller-in-foreclosure's written notice of cancellation, he must return, without condition, any original contract documents, such as the EP agreement bearing the seller's signature, to the seller within ten days following receipt of the notice. [CC §1695.6(c)]

Accordingly, the EP investor should not place funds in escrow before expiration of the cancellation period and a request for funds is made by escrow since an EP investor is not permitted to couple the release of funds to the return of documents on cancellation.

When the cancellation period expires for lack of a cancellation, the purchase agreement becomes enforceable and escrow can be closed, unless other contingencies exist.

Requirements for every EP investor

A homeowner defaults on a note secured by a trust deed on his principal residence, a one-to-four unit residential property. A Notice of Default (NOD) is recorded under a power-of-sale provision in the trust deed.

A private lender, who has **no knowledge** of equity purchase (EP) laws, orally agrees to refinance the property on the condition the owner transfers the property's title to the private lender. The private lender agrees to take title and refinance the existing loan on the property since he has good credit.

EQUITY PURCHASE AGREEMENT

DATE:_____________, 20______, at ____, California

Items left blank or unchecked are not applicable.

NOTICE: For use by buyers of one-to-four residential units which are owner-occupied and in foreclosure, when the buyer does not intend to occupy the property. [Calif. Civil Code §1695]

FACTS:

1 This agreement is for the purchase of property situated in the City of ____, County of __________________________________, California, described as:
Real estate:____
____
Personal property: ☐ See attached inventory;
____

2. This agreement is comprised of this five-page form and ______ pages of addendums/attachments.

TERMS: Buyer to pay the purchase price as follows:

3. Cash down payment through escrow in the amount of. . . . . $_______________

4. Take title subject to an existing first trust deed note held by _____________________________ with an approximate unpaid amount of. . . . . $_______________
payable $_______________ monthly until paid, including interest not exceeding _______%, ☐ ARM, type ________________________, plus a monthly tax/insurance impound payments of $_______________.
   4.1 The unpaid amount includes delinquent payments and foreclosure costs to be cured by Buyer in the amount of $_______________, representing monthly payments due beginning with the month of _____________, 20______.
   4.2 The impound account to be transferred without charge.

5. Take title subject to an existing second trust deed note held by _____________________________ with an approximate unpaid amount of . . . . $_______________
payable $_______________ monthly, including interest not exceeding ______%, ☐ ARM, type________________, due _____________, 20______.
   5.1 The unpaid amount includes delinquent payments and foreclosure costs to be cured by Buyer in the amount of $_______________, representing monthly payments due beginning with the month of _____________, 20 ______.

6. At closing, loan balance differences disclosed by beneficiary statement(s) to be adjusted into the purchase price, but if the balance exceeds the amount stated, the difference to be adjusted into the cash down payment.

7. Buyer to obtain a ☐ first, or ☐ second, trust deed loan in the amount of . . . . $_______________
payable approximately $_______________ monthly for a period of ______ years, interest on closing not to exceed ______% per annum, ☐ ARM, type _______________.

8. Assume a tax bond or assessment lien with an unpaid principal balance of. . . . . $_______________

9. A Note for the balance of the purchase price, in the amount of . . . . $_______________
to be executed by the Buyer in favor of Seller and secured by a trust deed on the property junior to any above referenced financing, payable $_______________ monthly, or more, beginning one month after closing, including interest at ______% per annum from closing, due _____________, 20______. [first tuesday Form 420]
   9.1 This note and trust deed will not contain provisions for due-on-sale, prepayment penalty or late charges.
   9.2 A Carryback Disclosure Statement is an attached addendum. [ft Form 300]

10. TOTAL PURCHASE PRICE IS THE AMOUNT OF . . . . $_______________

11. ACCEPTANCE AND PERFORMANCE:

11.1 This offer to be deemed revoked unless accepted in writing ☐ on presentation, or ☐ within _____ days after date, and acceptance is personally delivered or faxed to Offeror or Offeror's Broker within the period.

11.2 After acceptance, Broker(s) are authorized to extend any performance date up to one month.

11.3 On failure of the buyer to obtain or assume financing as agreed by the date scheduled for closing, buyer may terminate the agreement.

11.4 Any termination of the agreement shall be by written Notice of Cancellation timely delivered to the other party, the other party's broker or escrow, with instructions to escrow to return all instruments and funds to the parties depositing them. [ft Form 183]

11.5 Buyer's close of escrow is conditioned on Buyer's prior or concurrent closing on sale on a sale of other property, commonly described as: ____.

11.6 Both parties reserve their rights to assign and agree to cooperate in effecting an Internal Revenue Code §1031 exchange prior to close of escrow, on either party's written notice. [ft Forms 171 or 172]

11.7 Should Buyer breach the agreement, Buyer's monetary liability to Seller is limited to ☐ $_______________, or ☐ the deposit receipted in Section 1.

12. PROPERTY CONDITIONS:

12.1 Seller to furnish prior to closing:

a. ☐ a structural pest control inspection report and certification of clearance of corrective conditions.

b. ☐ a home inspection report prepared by an insured home inspector showing the land and improvements to be free of material defects.

c. ☐ a one-year home warranty policy:
Insurer: ____
Coverage: ____

d. ☐ a certificate of occupancy, or other clearance or retrofitting, required by local ordinance for the transfer of possession or title.

e. ☐ a certification by a licensed contractor stating the sewage disposal system is functioning properly, and if it contains a septic tank, is not in need of pumping.

f. ☐ a certification by a licensed water testing lab stating the well supplying the property meets potable water standards.

g. ☐ a certification by a licensed well-drilling contractor stating the well supplying the property produces a minimum of ______ gallon(s) per minute.

h. ☐ ____

i. ☐ ____

12.2 Seller's Condition of Property (Transfer) Disclosure Statement (TDS) [ft Form 304]

a. ☐ is attached; or

b. ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days after receipt, Buyer may either cancel the transaction or deliver to Seller or Seller's broker a written notice itemizing any material defects in the property disclosed by the statement and unknown to Buyer prior to acceptance [ft Form 269]. Seller to repair, replace or correct noticed defects prior to closing.

c. On Seller's failure to repair, replace or correct noticed defects under §12.2b or §12.3a, Buyer may tender the purchase price reduced by the cost to repair, replace or correct the noticed defects, or close escrow and pursue available remedies. [ft Form 183]

12.3 Buyer to inspect the property twice:

a. an initial property inspection on acceptance to confirm the property's condition is substantially the same as observed by Buyer and represented by Seller or Seller's agents prior to acceptance, and if not substantially the same, Buyer to promptly notify Seller in writing of undisclosed material defects discovered. [ft Form 269]. Seller to repair, replace or correct noticed defects prior to closing; and

b. a final walk-through inspection within five days before closing to confirm the correction of any noticed defects under §12.2b and §12.3a and maintenance under §11.10 [ft Form 270].

12.4 Seller's *Natural Hazard Disclosure Statement* [ft Form 314] ☐ is attached, or ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days of receipt, Buyer may terminate the agreement based on a reasonable disapproval of hazards disclosed by the statement and unknown to buyer prior to acceptance. [ft Form 182 and 183]

12.5 Buyer acknowledges receipt of a booklet and related Seller disclosures containing ☐ *Environmental Hazards: A Guide for Homeowners, Buyers, Landlords and Tenants* (on all one-to-four units), ☐ *Protect Your Family from Lead in Your Home* (on all pre-1978, one-to-four units) [ft Form 313], and ☐ *The Homeowner's Guide to Earthquake Safety* (on all pre-1960, one-to-four units). [ft Form 315]

12.6 The property is located in:
☐ an industrial use area; ☐ a military ordnance area; ☐ airport influence area
☐ ____

12.7 On acceptance, Seller to hand Buyer the following property information for Buyer's review: ☐ Property Operating Cost Sheet [ft Form 352 or 562]; ☐ Rental Income Statement. [ft Form 380]

a. Within ten days of receipt, Buyer may terminate the agreement based on a reasonable disapproval of the property information received.

12.8 Smoke detector(s) and water heater bracing exist in compliance with the law, and if not, Seller to install.

12.9 Possession of the property and keys/access codes to be delivered: ☐ on close of escrow, or ☐ as stated in the attached Occupancy Agreement. [ft Forms 271 & 272]

12.10 Seller to maintain the property in good condition until possession is delivered.

12.11 Fixtures and fittings attached to the property include but are not limited to: window shades, blinds, light fixtures, plumbing fixtures, curtain rods, wall-to-wall carpeting, draperies, hardware, antennas, air coolers and conditioners, trees, shrubs, mailboxes and other similar items.

12.12 Notice: The California Department of Justice, sheriff's departments, police departments serving jurisdictions of 200,000 or more and many other local law enforcement authorities maintain for public access a database of the locations of persons required to register pursuant to paragraph (1) of subdivision (a) of Section 290.4 of the Penal Code. The database is updated on a quarterly basis and a source of information about the presence of these individuals in any neighborhood. The Department of Justice also maintains a Sex Offender Identification Line through which inquiries about individuals may be made. This is a "900" telephone service. Callers must have specific information about individuals they are checking. Information regarding neighborhoods is not available through the "900" telephone service.

13. CLOSING CONDITIONS:

13.1 This transaction to be escrowed with ____.
Parties to deliver instructions to escrow as soon as reasonably possible after acceptance.

a. ☐ Escrow holder is authorized and instructed to act on the provisions of this agreement as the mutual escrow instructions of the parties, and draft any additional instructions necessary to close this transaction. [ft Form 401]

b. ☐ Escrow instructions, prepared and signed by the parties, are attached to be handed to escrow on acceptance. [ft Form 401]

13.2 Escrow to be handed all instruments needed to close escrow ☐ on or before ____________, 20______, or ☐ within ______ days after acceptance. Parties to hand escrow all documents required by the title insurer, lenders or other third parties to this transaction prior to seven days before the date scheduled for closing.

a. Each party to pay its customary escrow charges. [ft Forms 310 and 311]

13.3 The amount of any taxes, liens, bonds, assessments or other encumbrances on the property not referenced are, at Buyer's option, to remain of record and be deducted first from the cash down payment and then from any carryback note.

13.4 Buyer's title to be subject to covenants, conditions, restrictions, reservations, and easements of records.
____.

13.5 Title to be vested in Buyer or Assignee free of encumbrances other than those set forth herein. Buyer's interest in title to be insured under an ALTA form policy issued by ____________________ as a(n) ☐ Homeowner(s) policy (one-to-four units), ☐ Residential ALTA-R policy (vacant or improved residential parcel), ☐ Owner's policy (other than one-to-four units), ☐ CLTA Joint Protection policy (also naming the Carryback Seller or purchase assist lender), or ☐ Binder (to insure resale or refinance within two years).

a. Endorsements: ____

b. ☐ Seller, or ☐ Buyer, to pay the title insurance premium.

13.6 If an Owner's Association is involved, ☐ Buyer has received and approves, or ☐ Buyer on acceptance to be handed, copies of the association's Articles, Bylaws, CC&Rs, collection and lien enforcement policy, operating rules, operating budget, CPA's financial review, insurance policy summary and any age restriction statement.

a. No association claims for defects or changes in regular or special assessments are pending or anticipated. Current monthly assessment is $________________.

b. Seller is not in violation of CC&Rs, except ____.

c. Seller to pay association document and transfer fees.

d. Buyer to approve the association's statement of condition of assessments and confirm representations in subsection a. above as a condition for closing escrow.

e. Within ten days of the Buyer's post-acceptance receipt of the Homeowner's Association documents, Buyer may terminate the agreement based on a reasonable disapproval of the documents. [ft Form 183]

13.7 Buyer to furnish a new fire insurance policy covering the property.

13.8 Taxes, assessments, insurance premiums, rents, interest and other expenses to be prorated to close of escrow, unless otherwise provided.

13.9 Bill of Sale to be executed for any personal property being transferred.

13.10 If Seller is unable to convey marketable title as agreed, or if the improvements on the property are materially damaged prior to closing, Buyer may terminate the agreement. Seller to pay all reasonable escrow cancellation charges. [ft Form 183]

14. BROKERAGE FEE:

Parties to pay the below-mentioned Broker(s) a fee now due of ________________________________ as follows: Seller to pay the brokerage fee on the change of ownership. The Party wrongfully preventing this change of ownership to pay the brokerage fee.

14.1 Seller's Broker and the Buyer's Broker, respectively, to share the brokerage fee ________:_________.

14.2 Broker is authorized to report the sale, its price and terms for dissemination and use of participants in brokerage trade associations or listing services.

15. ☐ Attached is the Agency Law Addendum. [ft Form 305]

16. ☐ The Buyer's selling Broker hereby confirms he is a licensed real estate Broker and holds a bond issued by a security insurer for more than twice the property's fair market value.

17. CANCELLATION PERIOD:

The Seller has the below noticed right to cancel this agreement until midnight of the fifth business day following the day the Seller signs this agreement, or until 8 a.m. on the day scheduled for a trustee's foreclosure sale of the property, whichever occurs first.

NOTICE REQUIRED BY CALIFORNIA LAW:

Until your right to cancel this contract has ended,

____(Buyer)

or anyone working for

____(Buyer)

CANNOT ask you to sign or have you sign any deed or any other document.

You may cancel this contract for the sale of your house without any penalty or obligation at any time before ______:_____, ______.m. on _______________, 20______.

See attached notice of cancellation form for an explanation of this right. (To be filled out by Buyer)

Buyer's/ Selling Broker: ____________	Seller's/ Listing Broker:
By: ____________	By: ____________
Is the agent of: ☐ Buyer exclusively. ☐ Both Seller and Buyer.	Is the agent of: ☐ Seller exclusively. ☐ Both Seller and Buyer.

I agree to the terms stated above.	I agree to the terms stated above.
Date: ______, 20___	Date: ______, 20___
Buyer: ____________	Seller: ____________
Buyer: ____________	Seller: ____________
Signature: ____________	Signature: ____________
Signature: ____________	Signature: ____________
Address: ____________	Address: ____________
____________	____________
Phone: ____________	Phone: ____________
Fax: ____________	Fax: ____________
E-mail: ____________	E-mail: ____________

NOTICE OF CANCELLATION

(To be filled out by Buyer)

Seller signed the Equity Purchase Agreement on ______________, 20______.

You may cancel this contract for the sale of your house, without any penalty or obligation, at any time before ______:______, ______.m. on ______________, 20______.

To cancel this transaction, personally deliver a signed and dated copy of this cancellation notice, or send a telegram to ____ (Buyer)

at ____ (Business Address)

NOT LATER THAN ______:______, ______.m. on ______________, 20______.

I hereby cancel this transaction.

Date ______________, 20______

Seller's Signature: ______________________________

Seller's Signature: ______________________________

The owner will **remain in possession** and make monthly payments to the private lender. The owner will **recover title** when he pays off the private lender and assumes the refinancing.

The private lender is a real estate licensee, but at no time acts as an agent in the transaction. The private lender (erroneously) believes he is purchasing ownership to the real estate since he will receive a grant deed and remain the vested owner of the property until it is "repurchased and reconveyed" to the homeowner.

Without a written purchase agreement or escrow instructions to document the terms of the transaction, the **owner conveys title** to the private lender by a grant deed which is immediately recorded.

Concurrent with the conveyance, the owner enters into a written sale-leaseback agreement with the private lender, calling for the payment of "monthly rent." The lease agreement includes an "option" allowing the owner to repurchase title to the property on his payment of a fixed sum of money, being the balance due the private lender. The **sale-leaseback and option** agreement also states the private lender reserves the right to sell the property on the owner's default.

The owner receives no funds for his equity at any time. On acquiring title, the private lender pays off the existing trust deed loan with his own funds.

The private lender then **transfers** the property's title to himself and his spouse. The couple then **refinance** the property to recover their funds by obtaining a new first trust deed loan secured by the property. The private lender pays all costs relating to the new loan, including title insurance premiums, escrow fees and loan charges.

Later, the private lender **again refinances** the property when interest rates drop to increase his cash flow under the sale-leaseback and option agreement. Prepayment penalties are incurred on the payoff, as well as origination costs for the new loan.

The owner then defaults on the monthly payments due on the lease. A 3-day notice to pay rent or quit is served on the owner. Eventually, the owner is evicted from the property.

The private lender then **sells the property** to a buyer who is unaware of the owner's option rights to repurchase the property, called a *bona fide purchaser* (BFP). No sales proceeds remain after the loan is paid off, due to a decline in the property's value after taking title and the addition of two sets of refinancing charges. The owner receives no money from the sale.

The owner makes a demand on the private lender to recover the value of his **equity in the property** based on the property's value at the time of the sale-leaseback transaction.

Is the owner entitled to recover the amount of his equity from the lender?

Yes! The owner is entitled to recover money equal to the fair market value of his equity at the time he conveyed title to the private lender, less any funds he received from the private lender, which were none.

Recovery of the owner's lost equity is allowed since the **private lender violated** the EP laws by each of the following events:

- **acquiring recorded title** to the owner's principal residence, consisting of a one-to-four unit residential property in foreclosure, without first entering into a written purchase agreement which conforms to EP statutes [CC §1695.6(a)];

- **failing to document** in writing (a note) the terms for repayment of the loan [CC §1695.3(c), 1695.3(d)]; and
- further **transferring title** to the property (to the spouse and again to the resale buyer) without the written consent of the owner. [**Boquilon** v. **Beckwith** (1996) 49 CA4th 1697; CC §1695.6(e)]

Editor's note — The private lender in our facts should have structured the transaction as a conventional loan, evidenced by a note and secured by a trust deed on the property. Note and trust deed documentation of the loan would have avoided compliance with EP laws and the penalties for failure to comply due to the transfer of title. Title does not transfer when a trust deed lien is used to secure the repayment of a loan.

Brokers limited to listing property

Equity purchase (EP) legislation regulates brokers when they act as a **buyer's agent** for EP investors who attempt to buy an owner-occupant's home that is in foreclosure.

The broker **representing an EP investor** must, when negotiating an EP transaction, deliver to the seller-in-foreclosure a written **EP disclosure statement** that the buyer's agent representing the EP investor is:

- a **licensed** real estate broker; and
- **bonded** by a surety insurer for twice the property's fair market value. [CC §1695.17(a)]

If the buyer's agent fails to deliver the EP disclosure statement to the seller-in-foreclosure, directly or through the seller's listing broker, the EP agreement is **voidable** at the discretion of the seller any time before escrow closes. [See **first tuesday** Form 156 §16]

Also, the EP investor is liable to the seller-in-foreclosure for any **losses arising** out of the buyer's agent's nondisclosure of licensing and bonding requirements. [CC §1695.17(b)]

However, the EP investor would be entitled to *equitable indemnity* from his agent, a reimbursement for the seller's losses caused by the agent's nondisclosure. Equitable indemnity is available to the EP investor who, without active fault on his part, is forced by legal obligation to pay for losses created by his agent's nondisclosure. [**San Francisco Examiner Division, Hearst Publishing Company** v. **Sweat** (1967) 248 CA2d 493]

For the buyer's broker, obtaining a surety bond is generally economically prohibitive. Due to bonding requirements, licensed real estate brokers have essentially been removed from representing EP investors who want to locate and purchase owner-occupied, one-to-four unit residential property in foreclosure for EP investors.

Thus, EP investors are learning to "go it alone," now (and in the future), without brokerage assistance.

Further, sellers-in-foreclosure are denied the full assistance of their listing broker. The EP statutes, while restricting brokers who represent EP investors, have effectively wiped out the listing broker's ability to bring in one of his investors as a buyer and be a **dual agent** in an EP transaction.

Broker as principal

The EP legislation does not restrict the ability of an individual, who may coincidentally be licensed as a broker or sales agent, to act solely as a **principal** purchasing property as an investor in an EP transaction.

Thus, a licensed real estate broker or agent may himself be the EP investor, eliminating use of the agency law disclosure as well as avoiding licensee disclosure and bonding requirements. The licensed real estate broker or agent, acting solely as an EP investor, is a buyer who merely happens to hold a real estate license — a fact which does not need to be disclosed to the seller-in-foreclosure since the licensee is not also acting as an agent for anyone in the transaction.

Conversely, if a real estate broker **employed** as the listing broker by a seller-in-foreclosure decides to directly or indirectly buy his client's property, he **must disclose** to his seller-client that he is **also a principal** in the transaction. [Calif. Business and Professions Code §§10176(d), 10176(g), 10176(h)]

Representing the seller

Prudent brokers and agents are inclined not to solicit or accept an exclusive right-to-sell listing from a seller-in-foreclosure. Property in foreclosure must be sold and escrow closed before the date of the trustee's foreclosure sale to have fully performed the employment and be entitled to a fee.

Unless the delinquent loan is brought current prior to five business days before the trustee's sale or paid in full before the sales date, the home will be sold at the trustee's sale. [CC §§2924c(e), 2903]

The listing agent for a seller-in-foreclosure usually needs extra time to find a buyer and close escrow since the frequency of foreclosures is inversely related to the volume of sales. The time constraints imposed on the listing agent by a trustee's sale date, before which the listing agent must close any sale of the property, place extra pressure on the broker employed under an exclusive listing agreement to locate a buyer.

As always, the listing agent acting under an exclusive listing must perform his agency duties owed the seller by properly marketing the property with care and diligence. As a further complication, the seller-in-foreclosure expects the broker to save his equity by negotiating a sale of the property and closing escrow before the property is lost to the foreclosing lender.

If the insolvent seller loses his equity, he may claim a lack of due diligence or unprofessional conduct on the part of the broker to locate a buyer and close an escrow — a risk the broker and his agents take when listing a home which is in foreclosure.

Other EP agents

The agent placing a listing of an owner-occupied residence in a multiple listing service (MLS) when the residence is in foreclosure should advise participating buyer's agents that:

- the property is an owner-occupied residence which is in foreclosure; and
- the participating agent is to represent a buyer-occupant or be bonded if representing an EP investor.

Although purchase transactions by buyer-occupants are not controlled by EP law, buyer-occupants are frequently **unwilling to purchase** property in foreclosure since the property is often:

- **physically damaged or unattractive** due to deferred maintenance; and
- **improperly encumbered** since either the buyer cannot assume or will not assume the loan on the terms demanded, or the property cannot be refinanced for an amount sufficient to pay off the existing loan and the lender will not agree to a short payoff.

Thus, the property is attractive primarily to an investor-type buyer who is willing to take these risks. The property must be rehabilitated and financing and operating costs carried until the property is resold or rented — at a profit or a loss.

Two-year right of rescission

A Notice of Default (NOD) is recorded on a homeowner's personal residence after several months of unpaid installments.

The homeowner, now in foreclosure, is willing to sell on almost any terms to salvage his remaining credit and equity in the property.

The property is listed with a broker. The broker's listing agent markets the property primarily to buyers who will occupy the property as their personal residence.

However, an offer is submitted directly to the seller-in-foreclosure by an EP investor, acting on his own account, without broker representation. Under the EP offer, the seller-in-foreclosure will receive cash for his equity. Additionally, the EP investor will cure the seller's loan delinquencies.

The seller-in-foreclosure contacts his listing broker who, after reviewing the offer, recommends the seller accept the EP investor's offer and, if an acceptable backup offer is received within the cancellation period, accept the backup offer and cancel the EP agreement.

The agent advises his client he has five business days after his acceptance of the EP offer to cancel the sale since the sale involves the seller's home, which is in foreclosure.

The seller-in-foreclosure accepts the EP investor's offer. The five-day cancellation period expires without receiving a backup offer and escrow is opened on the EP agreement. The EP transaction is later closed and the property conveyed.

Does the EP investor receive good title when he accepts the grant deed?

No! The EP investor's title remains subject to the seller-in-foreclosure's *right of rescission* for two years after closing. If at any time during the two years following the close of escrow and the recording of the grant deed conveyance the seller believes the **EP investor's conduct** and the **price paid** gave the EP investor an *unconscionable advantage*, the seller may attempt to rescind the transaction and recover the home he sold. [CC §1695.14]

The unconscionable advantage

The two-year rescission period only allows a seller-in-foreclosure to recover property if he can demonstrate the EP investor took *unconscionable advantage* of him when negotiating the purchase of the property.

Showing the existence of an unconscionable advantage in the **EP investor's conduct** is problematic for both the seller-in-foreclosure and the EP investor. The legislature has not defined what exactly constitutes an act of unconscionable advantage by the buyer.

What was a reasonable sales price under the circumstances surrounding the seller-in-foreclosure when the transaction was entered into might appear to be unconscionable to the seller in the future due to market factors and inflation, not the conduct of the EP investor. Thus, an EP investor assumes the risk that a rising economy may provoke the seller into attempting to rescind (for the wrong legal reason).

If real estate values rise rapidly and significantly, the "greed factor" may set in, turning a formerly desperate seller-in-foreclosure into an astute rescinding seller.

However, any **increase in the value** of the property after acceptance of the EP investor's offer may not be considered. The test of unconscionable advantage is not determined based on events occurring after the seller-in-foreclosure enters into the purchase agreement.

Market circumstances existing at the time of the negotiations or when the parties entered into the agreement are the economic considerations which form one of the two elements for testing unconscionable advantage. [**Colton** v. **Stanford** (1890) 82 C 351]

Unconscionability has two aspects:

- the lack of a **meaningful choice** of action for the seller-in-foreclosure when negotiating to sell the home to the EP investor, legally called *procedural unconscionability*; and
- a purchase price or method of payment which is **unreasonably favorable** to the EP investor, legally called *substantive unconscionability*.

The **price paid**, like any other provision in a purchase agreement, can be considered unconscionable. When determining the unconscionability of the purchase price, justification for the price at the time of the sale and the terms of payment will be examined.

An **unconscionable method of payment** could include:

- carryback paper with an unreasonably low interest rate, long amortization or a due date on the note that bears no relationship to current market rates and payment schedules; or
- an exchange of worthless land, stock, gems or zero coupon bonds at face value with a 20-year maturity date.

A form of payment which is uncollectible, unredeemable and with no present value would be unconscionable.

However, the existence of unreasonable pricing and payment alone is not enough to show the unconscionable advantage needed to rescind a closed transaction. Both the lack of a meaningful choice and unreasonably favorable (advantageous) terms must exist to show unconscionability existed.

The un-American low price

Any procedures used or conduct employed by an EP investor as a misfeasance or misrepresentation made to deprive the seller-in-foreclosure of a reasonable choice between the EP investor's offer and offers from other buyers must exist to establish the lack of a meaningful choice or alternative to the EP investor's offer.

An unconscionable advantage occurs if the EP investor **exploits** an element of **oppression or surprise** in exacting an unreasonably low and favorable purchase price or terms of payment.

Oppression by the EP investor exists when the inequality in bargaining power between the investor and the seller-in-foreclosure results in no real negotiations between them — a "take it or leave it" environment deliberately removed from competing buyers. The foreclosure environment itself often presents a one-sided bargaining advantage for the EP investor to exploit should he decide he does not want his offer "shopped around" to solicit a better deal from other buyers during the five-business- day cancellation period.

Surprise occurs due to the post-closing discovery of terms which are hidden in the lengthy provisions of the agreement. The price and how it will be paid is not a surprise. The price is well known to the seller-in-foreclosure and, on any rescission action by the seller, will likely be the only term of the agreement contested by the seller.

The greater the marketplace oppression or post-closing surprise discovery in the transaction, the less an unreasonably favorable price paid by an EP investor will be tolerated. [**Carboni** v. **Arrospide** (1991) 2 CA4th 76]

Structuring the EP agreement

An investor, not intending to be an owner-occupant buyer, wants to purchase single family residences (SFRs) for investment purposes.

The investor locates an owner-occupied SFR encumbered by a trust deed on which a Notice of Default (NOD) has been recorded, commencing a trustee's foreclosure.

Because the seller occupies the residential property and an NOD has been recorded, the **investor realizes** he must comply with California's EP laws when preparing and submitting an offer to purchase the property.

The EP investor is willing to purchase the SFR for a price of $140,000 on the following terms:

- **pay** $10,000 cash to the seller-in-foreclosure for his equity in the property;
- **take over** the existing loan with a total of $130,000 due the lender in unpaid principal, delinquent installments and foreclosure costs; and
- **pay** the delinquent installments of principal, interest, taxes and insurance (PITI) and the foreclosure costs of approximately $7,400 — all of which are included in the $130,000 owed the lender on the loan.

The EP agreement calls for a $10,000 cash down payment.

Also, the EP investor will take title to the property "subject to" the existing first trust deed with a 28-year amortization remaining.

The conditions of the trust deed note are:

- $122,600 of remaining principal (after the delinquent payments have been brought current);
- 6.5% interest;
- $802.30 monthly principal and interest payments;
- $150 monthly taxes/insurance impounds payments;
- current five month delinquencies on PITI of $4,761.50; and
- foreclosure costs of $1,316.80.

The first trust deed is a loan insured by the Federal Housing Administration (FHA) subject to the Department of Housing and Urban Development (HUD) due-on-sale rules controlling investor purchases. However, only HUD, not the lender, has the right to call a HUD-insured loan. The likelihood of HUD calling any loan which is kept current is remote. Thus, the loan may be taken over by the EP investor "subject to" with minimal interference from the lender, i.e., assumption fees and loan modification are avoided.

Editor's note — As of the date of this text, FHA is suffering a 12% delinquency rate on its insured loans.

The seller-in-foreclosure will not be carrying back a portion of the purchase price since this is a cash-to-loan transaction. As an alternative method for payment of the purchase price, negotiations could have included provisions for the seller to carryback paper in the EP transaction.

The seller-in-foreclosure is five months delinquent in payments. The EP investor will bring the $4,761.50 in delinquent PITI payments current, which includes $326.66 in principal reduction.

Taxwise, the payment of the delinquent principal and interest (PI) payments (not the impounds) is part of the EP investor's original **costs of acquisition**. The interest paid by the EP investor which accrued **before acquiring** the property is an expense of the seller-in-foreclosure, not the EP investor. Thus, the payment of the seller's debts must be capitalized by the EP investor as part of his *cost basis* in the property. [Internal Revenue Code §1012]

The EP investor's cost basis on acquisition of the property will be the purchase price of approximately $140,000, which includes the seller-in-foreclosure's delinquent (PI) installments, foreclosure costs and the principal balance on the loan, less the impound account balance.

A prudent EP investor will determine the total cash funds needed to close escrow before making an offer. Cash expenditures of the EP investor on closing include:

- a down payment of $10,000.00;
- delinquent principal, interest, taxes and impounds of $4,761.50;
- foreclosure costs of $1,316.80;
- escrow fees and charges of $300.00; and
- a total cash investment of **$16,378.30**.

Chapter 19 — The breaching buyer's liabilities

This chapter digests the buyer's liabilities to a seller, arising out of the buyer's breach of a purchase agreement, for property value decreases, operating and carrying costs, and losses on a resale.

First, there must be a money loss

Consider a prospective buyer of a residence who is informed the seller has already entered into a purchase agreement to acquire a replacement residence. The seller is relying on the sale of his current residence to fund his purchase of the replacement residence.

The prospective buyer makes a written offer agreeing to pay cash for the seller's equity and assume the existing trust deed loan, called a *cash-to-loan transaction*. The seller accepts the offer. Escrow instructions are prepared and signed, and the buyer's good-faith deposit is placed in escrow.

Later, as agreed, the buyer deposits additional funds in escrow. Although escrow is not yet ready to close, the buyer agrees to release some of the downpayment money held in escrow so the seller can close his purchase of the replacement residence. The funds are released and the seller acquires his new residence.

The seller vacates the old residence he has *sold* and moves his family and belongings into the new residence.

To consent to the buyer's application to assume the seller's existing loan, the lender demands a modification of the interest rate and payment schedule, and an assumption fee. The buyer refuses to proceed with the loan assumption and cancels escrow.

The buyer makes a demand on the seller to return all funds the buyer deposited into escrow, which the seller rejects.

The seller then makes a demand to be paid the funds remaining in escrow. The seller claims the buyer has *forfeited* all funds since he breached the purchase agreement by not assuming the loan.

The seller promptly relists the property and it is **resold** for the same price, but on terms calling for payoff of the existing loan, requiring the seller to pay a prepayment penalty. The seller also agrees to pay the new buyer's nonrecurring closing costs and one point on new financing to be obtained by the new buyer. On closing the resale transaction, the seller's net proceeds are less than he would have received on the sale to the original buyer under the breached purchase agreement.

Can the seller recover any money from the original buyer by either:

- retaining all the funds deposited by the buyer; or
- accounting for offsets against the buyer's deposits for the seller's losses?

Here, the seller is entitled to recover his losses. However, he must **account for his actual money losses** caused by the buyer's breach since a forfeiture of deposits is not allowed, no matter the wording or initialing of the forfeiture provisions. Depending on the amount of the seller's **total recoverable losses** on

the resale, the buyer's deposit will be partially or totally offset by the amount of the seller's losses caused by the breaching buyer. [**Allen** v. **Enomoto** (1964) 228 CA2d 798]

Recoverable seller losses

A seller's **total recoverable losses**, summarized here and analyzed in detail in this chapter, include:

- the **operating and carrying costs** of trust deed interest payments, taxes, insurance, maintenance and utilities, which were incurred by the seller during the period between the date of the breach and the date escrow closed on the resale;
- the **increased closing costs** due to the seller's payment of the new buyer's nonrecurring closing costs and financing fees on the resale which reduced the seller's net proceeds compared to the net proceeds the seller would have received from the breaching buyer;
- the **additional resale costs** of the prepayment penalty demanded by the lender on the loan payoff; and
- **interest** on the seller's net equity from the date escrow was to close to the date of closing on the resale.

Resell or retain the property

A seller of real estate who is faced with a breaching buyer and the loss of the sales transaction must first decide whether to:

- **enforce** the purchase agreement and have a court order the buyer to close escrow, called *specific performance*;
- **remarket** the property for sale promptly and diligently seek to locate a buyer; or
- **retain the property** and postpone or entirely forego any resale effort.

Editor's note — This chapter illustrates money losses recoverable by the seller who chooses either to retain the property or resell it. Thus, the specific performance remedy is not considered here.

Only a money loss is recoverable

A buyer, due to his breach of the purchase agreement, owes the seller **actual money losses**, called *damages*, which are classified as:

- **general damages**, also called *normal damages*, being the dollar amount of any decline in the property's fair market value as of the date of the buyer's breach below the price agreed to in the purchase agreement;
- **special damages**, also called *consequential damages*, being 1) transactional costs incurred by the seller while preparing to close under the breached purchase agreement, 2) marketing expenses, increased closing costs, and ownership and operating costs incurred to remarket and sell the property, and 3) any further drop in property value after the buyer's breach for so long as the buyer interferes and stalls the seller's resale effort; and
- **interest** from the date of the buyer's breach to the closing date of a resale of the property on all money and any carryback note the seller was to receive [Calif. Civil Code §3307]; less
- **offsets or credits** due the buyer for 1) any rent received from tenants or the *implicit rent* for the owner's use of the property, 2) the amount of any price increase on the resale, and 3) the amount of any reduction in the seller's expenses on the resale, so the seller will not be placed in a better financial position than he would have been in had the breaching buyer fully performed. [**Smith** v. **Mady** (1983) 146 CA3d 129]

Price-to-value as a money loss

When a seller decides to resell the property after the buyer breaches their purchase agreement and the property's value has declined below the price set in the purchase agreement, the seller has incurred a **loss in value** which is recoverable from the buyer. However, the amount of future value decline recoverable after the buyer's breach is limited to two time periods:

- the initial decline in value below the purchase price during the period **before the breach**, which is recoverable as *general damages* or more commonly called a *price-to-value loss*; and
- any further decline in value **after the breach**, which is recoverable only if the buyer **interferes** with the seller's resale effort, also called *special damages* or more commonly called *additional damages*, damages being money. [CC §3307]

The price-to-value loss on the date of breach is recoverable whether the property is retained, remarketed or resold.

During periods of reduced regional economic activity, the boom-bust cyclical nature of real estate sales typically causes California property values to drop dramatically below the price the buyer agreed to pay just a few months earlier. Further, the intangible impacts on a property's market value, due to its "shop-worn" listing status and the "fall-out syndrome" of a lost sale, give the property an aura in the local real estate market which negatively affects some buyers and their brokers. This aura is often reflected in a further dampening of the property's value on the date of breach. [**Bouchard** v. **Orange** (1960) 177 CA2d 521]

To limit the breaching buyer's liability, the seller's loss on a resale at a price lower than the price agreed to by the breaching buyer is limited to the amount of the value decline which occurs by the date of the buyer's breach, not the date of resale. Any further decline in value after the date of breach to the date of resale (or trial, if the property is not yet resold) is recoverable only if the buyer interferes with the seller's diligent resale efforts.

Same or greater price on resale

When property is resold for the same price agreed to by a breaching buyer, or more, and the net proceeds from the resale are the same or the cash equivalent, or more, the price-to-value decline on the date of breach is no longer recoverable. With equal or greater net proceeds on a resale, the seller incurs no money loss, called *general damages*, since he has no loss of value to recover.

To set the dollar amount of the price-to-value loss on the date of breach, any "noncash" terms for payment of the purchase price by the breaching buyer and any "noncash" terms for payment of the resale price are adjusted to their **cash equivalency**.

For example, if terms for payment of a sale price include a seller carryback note, the principal amount of the carryback note is adjusted downward to reflect any discount required to convert the carryback paper to its cash equivalent, i.e., its present worth in cash.

Interfering with the resale

A seller might **diligently remarket** the property and still be unable to resell it due to interference from the breaching buyer. Buyer interference with resale efforts usually consists of filing a *specific performance action* and recording a *Notice of Lis Pendens*, or taking possession and refusing to vacate.

When the breaching buyer interferes with the resale, the seller recovers any decline in the property's value after the date of breach until the buyer stops interfering with the seller's efforts.

For example, a buyer sues a seller seeking specific performance of the purchase agreement. The seller claims the buyer breached the purchase agreement by failing to satisfy contingencies as scheduled. The buyer claims the seller breached when he canceled, thus *excusing* the buyer from further performing. The buyer sues to recover the property and records a **Notice of Lis Pendens**, which clouds the marketability of title.

Ultimately, the buyer is held to have breached the agreement and the lis pendens is removed from the record, called *expungement*.

A seller, whether he attempts to resell the property or retains it, generally bears the risk of any fluctuation in the value of the property after the buyer breaches. The breach is the cutoff date for recovery of a decline in value, unless the buyer later interferes.

However, the risk of loss due to a decline in value after the date of breach is shifted to the buyer until the date title is cleared of the recorded lis pendens if the recording interferes with the seller's prompt and diligent efforts to resell the property. [**Askari** v. **R & R Land Company** (1986) 179 CA3d 1101]

Natural-consequence expenses

A seller who takes the property off the market or is not prompt and diligent in his efforts to remarket and resell it after the buyer's breach is limited in his recovery of money to his **actual transactional expenses** and any **operating expenses** incurred to fulfill the seller's performance under the purchase agreement up to the time of the buyer's breach.

Recoverable money losses the seller might incur as **transactional expenditures** include:

- escrow and title charges;
- lender charges for beneficiary statements or payoff demands;
- lender or carryback seller charges to process the buyer's credit clearance, loan application or loan assumption; and
- other expenses and property reports incurred in reasonable reliance on the buyer's full performance of the purchase agreement.

However, **ownership and operating expenses** incurred by a seller who chooses to either retain the property or delay reselling the property are not recoverable. The seller, as the owner of the property, remains responsible for the expenses of carrying and maintaining the property since these expenses are not incurred by the seller due to a buyer's agreement to purchase or a breach by the buyer. These expenses are incurred because the seller owns the property.

However, some operating losses incurred by a seller due solely to his **compliance** with the terms of a purchase agreement are recoverable, including:

- the seller's relocation expenses to reoccupy the property if he vacated after all contingencies allowing the buyer to cancel were eliminated;
- rental income lost after the breach on units left vacant or vacated by the terms of the purchase agreement;
- a crop revenue loss due to the planting season having passed at the time of the buyer's breach; and

- a price drop on the late harvest of a crop due to the buyer's breach. [**Wade** v. **Lake County Title Company** (1970) 6 CA3d 824]

Replacement property

Consider a buyer who enters into a purchase agreement knowing the seller intends to acquire replacement real estate with the net proceeds from the sale. After all the buyer's contingencies are eliminated and no uncertainties remain about the buyer's full performance, the seller enters into a purchase agreement to buy replacement property without conditioning his purchase on the "sale of other property."

The buyer then breaches and the seller is unable to complete his purchase of the replacement property. The seller incurs expenses and losses to avoid liability for having unconditionally agreed to purchase the replacement property.

Expenses incurred on the replacement property transaction are recoverable since:

- the buyer knew when he entered into the purchase agreement that the seller intended to contract to purchase replacement property based on the buyer's agreement to purchase; and
- the seller agreed to purchase other property in reasonable reliance on his buyer closing the sales escrow since all contingencies had been removed and no obstacles to closing existed, except for the breach. [**Jensen** v. **Dalton** (1970) 9 CA3d 654]

Operating losses during the resale period

A seller who, after his buyer breaches, promptly takes steps to diligently remarket the property for sale may recover his operating expenses and carrying costs of the property incurred **after the date of breach**, subject to offsets for rent credit, owner's use, etc.

Recoverable operating losses and carrying costs are limited to those the seller incurs during the period beginning on the buyer's breach and ending on:

- the date a **resale closes**;
- the **trial** judgment on the breach; or
- the date of **withdrawal** of the property from the resale market, whichever occurs first.

The seller who decides to promptly resell the property and then recover any losses from the buyer has a duty to the breaching buyer to limit the operating and ownership losses, called *mitigation of damages*. To do so, the seller must take immediate steps to market the property for resale within the shortest possible time. [**Spurgeon** v. **Drumheller** (1985) 174 CA3d 659]

To begin calculating the seller's net loss, the seller's costs of maintaining his ownership are totalled. However, the recoverable operating expenses and carrying costs of the property incurred by the seller during the resale period are limited to operating and ownership expenses understood by the buyer to exist at the time he entered into the purchase agreement.

However, the buyer is **due a credit** for the rental value of the seller's occupancy, called *implicit rent*, and any rental income received by the seller from the property after the buyer's breach.

Thus, for a sale to recover on-going losses incurred to carry the ownership of the property before resale or trial, a full accounting of income, expenses and the carrying costs of financing is required. [See **first tuesday** Form 352]

Interest on recovered losses

A seller is also **entitled to interest** on the losses and expenditures he recovers for the decline in the property's value, expenses of the breached transaction, resale related expenses and the carrying costs of the property during the resale effort. [CC §3307]

Unless the purchase agreement states otherwise, the interest is collectable at the legal annual rate of 10%, accruing from the date the recoverable loss or expenditure was incurred, called *prejudgment interest*. [CC §3289(b)]

If the seller **retains the property**, no property operating or value losses after the breach are recoverable on which interest can accrue.

For the seller who **diligently remarkets** the property for resale, recoverable resale costs and out-of-pocket carrying costs of the property not offset by rental income or the rental value of the seller's use of the property accrue interest from the date of each expenditure.

Had the buyer performed and closed escrow, the seller would no longer own the property. The seller would have received the net sales proceeds for his equity in the property.

Since escrow did not close and the seller did not receive the net sales proceeds for his equity, the question of whether he is entitled to interest on his **net equity** turns on the seller's use of the property at the time the purchase agreement was entered into.

For example, a **seller's use** of the subject property falls into one of two categories:

- **income-producing property** used as the seller's residence or to house the seller's trade or business (implicit rent) or held out as a residential or nonresidential rental; or
- **nonincome-producing property**, such as vacant land or the seller's vacant residence.

Rents received from income producing property are the **economic equivalent** of interest on the equity. Thus, for the seller to also receive interest on his equity in income-producing property until it resells would be a nonrecoverable windfall, a double recovery on his equity in the form of interest and rent, which are economic equivalents. Should the seller occupy the property until it is resold, the value of his use is *implicit rent* and is an offset against all money recoverable from the breaching buyer, including interest on the seller's equity.

For vacant unused land or the seller's vacant residence, a breach by the buyer again fails to convert the seller's equity into cash or cash equivalent. Thus, the seller temporarily retains ownership of the equity, which may be increasing, decreasing or remaining the same depending on price fluctuations for the property's market value until it is resold.

Since the resale seller cannot recover his equity in vacant property from the breaching buyer (except by specific performance), can interest be collected on the equity?

First, any interest due on the dollar amount of the net equity can only accrue from the **scheduled closing date** of the breached contract — the date the benefits from the breached sale in the form of cash for the seller's net equity would have been received by the seller — up to and ending on the **date of resale or trial**. Any interest due accrues at the legal rate of 10%. However, if the seller agreed to an installment sale, the note rate for the carryback paper would be the controlling rate.

Next, if the breached purchase agreement contains a provision limiting the dollar amount of losses the seller can collect, the losses recoverable would be controlled by the agreed-to limit, except for the accrual of interest which would be an additional amount. [See **first tuesday** Form 150 §10.7]

Thus, when the buyer breaches an agreement to purchase vacant, nonincome-producing property, interest is due on the net sales proceeds the seller would have received on the sale, until the property is resold.

Chapter 20 Community property

This chapter discusses the effect a marriage has on a spouse's ability to sell real estate.

The broker's role

A broker who represents a married person in the sale, lease or financing of community real estate must know whether the performance of the married person under a listing (paying the fee) or a transactional purchase agreement (closing escrow) can be avoided by community property defenses in order to inflict a loss on the broker.

For example, a broker obtains an *exclusive right-to-sell listing* signed only by the wife. The real estate listed is community property, vested in the name of the husband and wife as joint tenants.

During the listing period, the husband and wife sell the property without the aid of the listing broker. The listing entitles the broker to a fee if the property is sold by anyone during the listing period. [See **first tuesday** Form 102 §4.1(a)]

The broker claims both the husband and wife are liable for the brokerage fee since the property was sold during the listing period.

The wife claims the listing is unenforceable without the husband's signature since the property listed cannot be sold and conveyed without her husband's written consent.

Is the broker entitled to his fee?

Yes! While the husband, who did not sign the listing agreement, is not personally liable for the brokerage fee, the wife is liable for the fee since she signed the listing agreement. The broker's enforcement of his fee agreement under the listing is an action for money due on an employment agreement, not an action for specific performance of a real estate purchase agreement — which would require both spouses' signatures. [**Tamimi** v. **Bettencourt** (1966) 243 CA2d 377]

Judgment against a spouse

Further, on recording an *abstract* of the judgment against the wife for the brokerage fee, the judgment becomes a lien on any community real estate owned by the couple. The husband's separate property, however, is not liened and is unaffected by the abstract.

Now consider a husband who encumbers community property with a trust deed, executed by the husband alone without the consent of the wife, to secure a note which evidences a loan.

Later, the trust deed held by the lender is set aside in an action by the wife to clear title of the trust deed since the wife did not consent to the encumbrance — financing — of the community property.

The husband defaults on the now unsecured loan. The lender obtains a money judgment against the husband and records an abstract of the judgment.

The abstract now attaches as a lien to the same community property which had been previously encumbered by the voided trust deed.

Later, the couple's marriage is dissolved and the wife is awarded sole ownership of the community property.

The wife claims the property cannot be attached by the money judgment lien since the debt which became the money judgment had been secured by the same property under a trust deed the court declared void.

However, when the abstract of judgment against the husband was recorded, the abstract created a valid lien on all of their community property, including the property now solely owned by the wife. The judgment attached to the property while it was still community property, before the dissolution of the marriage. [**Lezine** v. **Security Pacific Financial Services, Inc.** (1996) 14 C4th 56]

Transfer by transmutation

A husband and wife divide their community assets between them so they can now conveniently pass the assets on to their children from previous marriages.

The husband and wife do not provide for the division of the funds received by the husband from his pension fund. However, the money from the pension is community property, even though the pension is vested only in the husband's name.

The husband places funds received from the pension into an individual retirement account (IRA) vested in the name of the husband's revocable living trust. The husband obtains the wife's consent to the deposits, acknowledging she is not to be named as a beneficiary on the IRA account.

Later, the wife asserts an interest in the IRA, claiming the funds are community property.

The husband claims the wife transmuted her community property interest into his separate property when she signed the consent form for the change in vesting.

Does the wife have a community property interest in the husband's IRA?

Yes! For a written declaration to express an intent to *transmute property* from a community asset to a separate asset of one spouse, the declaration signed must contain an **explicit statement** confirming the spouse conveys and terminates the community property interest held in the property.

The use of the word transmutation is not required in a **transfer document** to transmute property. A transmutation would have taken place had the consent agreement contained the provision, "I give to the account holder any interest I have in the funds deposited in this account." [**In re Estate of MacDonald** (1990) 51 C3d 262]

Now consider a husband and wife who buy property with money they earned during their marriage. Escrow is instructed to vest title to the property in the wife as her sole and separate property.

Concurrent with the recording of the grant deed to the wife, the husband signs a quitclaim deed (or joins in the grant deed as the husband of the grantee) clearing title of any interest he may have in the property.

Later, the property is sold and the wife's conveyance is insured by a title company as a transfer of the entire fee ownership of the property. The husband does not sign and record another quitclaim deed, or join in the wife's conveyance.

The title insurance company considers the husband's quitclaim deed on his wife's acquisition of title to the property to be the only conveyance required since the quitclaim deed was recorded.

Within one year after recording the wife's conveyance, the husband seeks to set aside the sale as voidable.

The husband claims the original quitclaim deed was not a transmutation of their community property into the separate property of his wife since they only intended to vest the property so his name did not appear of record.

Is the quitclaim deed a written declaration which changed the characteristics of the property from community to separate ownership by the other spouse?

Yes! The husband's *execution* (signature and delivery) of the quitclaim deed transferred his interest in the community property to his wife as her separate property since the deed released all interest held in the property. Thus, the spouse's quitclaim deed transmuted the community property into the separate property of the other spouse. [**In re Marriage of Broderick** (1989) 209 CA3d 489]

A **transmutation occurs** when a married individual or couple transfers personal or real property from:

- community property to a separate property interest of one spouse;
- a separate property interest of one spouse to community property; or
- a separate property interest of one spouse to the separate property interest of the other. [Calif. Family Code §850]

Unrecorded transmutations

A transmutation occurring after 1984 must be *written and recorded* to be effective against persons relying on the record title. The recording requirement gives **notice to others** who rely on the recorded title (title insurance companies) and whose rights may be affected by a transmutation (family members). [Fam C §852]

For example, an individual acquires property as his sole and separate property.

Later, and after 1984, the individual marries. The individual, now a spouse, transmutes his separate property to community property by handing his wife a signed deed from himself to himself and his spouse as husband and wife. However, the deed which transmuted the property is never recorded.

Later, the husband sells and conveys the property. Within one year after the sales transaction closes, the wife seeks to set aside the sale, claiming she did not consent to the sale of the community real estate.

The buyer claims he (and his title insurer) can rely on the record title which showed the property to be vested only in the husband as his sole and separate property.

Can the sale of the community property be set aside by the wife?

No! The transmutation of the husband's separate property to community property was never recorded. The buyer (and the title insurer) can rely upon the record title. [Fam C §852(b)]

Editor's note — This situation is unlikely to occur unless the broker involved representing the buyer knows the transmutation rules and presses the title company to issue a policy. Title insurance companies do not readily insure the conveyance by a spouse who is the sole vested owner until the off-record spouse delivers a quitclaim deed or joins in the conveyance.

However, no reported case or statute suggests a community interest accrues which can be adjudicated and enforced against a buyer or a lender. Title companies insuring conveyances on property acquired post-1984 or acquired prior to a post-1984 marriage can and should rely on the record title.

Community status imputed to buyer

Both spouses must consent to the sale, lease for more than one year or encumbrance of the community real estate. [Fam C §1102]

If one spouse, without the consent of the other, sells, leases for more than one year or encumbers the community real estate, the nonconsenting spouse may either ratify the transaction or have it set aside. The nonconsenting spouse has **one year** from the recording of the nonconsented-to transaction to file an action to set the transaction aside. If the third party to the transaction — the buyer, tenant or lender — has no notice of the marriage, the transaction cannot be set aside. [Fam C §1102]

However, consider a **buyer's broker** who has knowledge the seller of real estate is married and was married when he acquired the property being sold. The broker does not inform his buyer (or the title company) of the seller's marital status. The property is vested of record in the name of the seller only, with no recorded reference to his married status.

Later, and within one year, the nonconsenting spouse learns of the sale and files suit to avoid the transaction claiming a community property interest in the real estate. The buyer claims he is a bona fide purchaser, unaware of the marital relationship at the time of the sale.

However, the knowledge of the buyer's broker is *imputed* to the buyer since the broker is the buyer's agent. Thus, the nonconsenting spouse is able to set aside the sale of the property, even though the buyer himself was actually unaware of the marriage. [**Waldeck** v. **Hedden** (1928) 89 CA 485]

LLC as a vesting

To circumvent the need to obtain quitclaim deeds or determine whether a transmutation has occurred, the real estate could be vested in a limited liability company (LLC) solely owned by one spouse, or owned by both spouses with only one spouse as the manager of the LLC.

For instance, a wife can transfer her separate property to an LLC, and manage and control the property as the manager of the LLC. While the LLC owns the real estate, the wife owns the LLC as its sole member.

As manager, the wife is able to sell, encumber or lease the property in the name of the LLC — without the spouse's consent. [Calif. Corporations Code §§17052(f); 17157]

Other instruments and entities which can be used to authorize one spouse to manage and control community property include:

- a power of attorney;
- a revocable trust in which one spouse is the named trustee [Fam C §761(c)]; or
- a limited partnership. [Corp C §15621]

Chapter 21 — The right of survivorship among co-owners

This chapter presents the joint tenancy and community property with right of survivorship vestings for the co-ownership of real estate, and explains their creation and application as well as severance of the vesting and termination of the right of survivorship.

Vesting is always estate planning

A husband and wife, with the assistance of their broker, locate real estate they want to buy. They will use funds accumulated during the marriage and proceeds from a new loan to pay the purchase price.

Their broker, as part of his due diligence on any acquisition, asks the couple how they would like to take title to the property on the close of escrow. The broker determines the couple would like the property vested in both of their names, as husband and wife, with the right of survivorship. On the death of a spouse, they want the surviving spouse to automatically become the sole owner of the property and avoid probate procedure entirely.

Also, the couple is not interested in vesting title under a *revocable inter vivos (living) trust* agreement which would avoid probate — the surviving spouse taking all property on the death of the other.

The broker recognizes the community property aspect and recommends they take title in their names, such as *"husband and wife as community property with right of survivorship,"* rather than "as joint tenants." The broker explains the two vestings are identical for conveyancing since:

- both vestings can be *severed* before death to provide for an alternative distribution of the couple's interests to others by will or by a trust agreement; and
- on death the title is cleared at any time by the surviving spouse recording an *affidavit* declaring the death of the decedent and attaching a certificate of death. [Calif. Civil Code §§210; 682.1(a); see **first tuesday** Form 461]

Mindful of the **tax consequences** for the surviving spouse, as well as the occasional and incorrectly voiced concern that a joint tenancy vesting alone might somehow transmute community property into the separate property of each spouse, the broker feels the couple should vest title to the acquisition as "community property with right of survivorship." Taxwise, the surviving spouse, as with a joint tenancy vesting, would be assured a fully stepped-up *cost basis* for the community property. [See Joint tenancy tax aspects, *post*]

Here, the broker's advice to vest the community property as "community property with right of survivorship" satisfies the couple's estate planning needs for holding title. The acquisition is during the marriage and thus is community property — even if the couple had vested the property as joint tenants. Also, the couple simply wish to avoid probate procedures and administration. Either right of survivorship vesting avoids enforcement of any contrary provisions in the will of the deceased joint tenant since no interest remains to be transferred.

Thus, for the surviving spouse, a community property vesting with the right of survivorship is a better vesting than a simple community property vesting — even though a community property vesting (without the right of survivorship) also transfers the property to the surviving spouse if the deceased dies *intestate* (no will) or *testate* (with will) stating the surviving spouse takes the property.

On a simple community property vesting, if no one contests the surviving spouse's right to become the sole owner of the deceased spouse's interest in the property, the surviving spouse must wait 40 days following the death before the property can be sold, leased or encumbered. After 40 days, an affidavit by the surviving spouse is recorded to clear title by declaring the death and including a certificate of death. [See **first tuesday** Form 461]

A joint tenancy recommendation by the broker would produce the same results during ownership (transferability) and on death (taxes) as would the community property vesting without the right of survivorship. Additionally, joint tenancy allows avoidance of some community debts during the marriage and on death. This avoidance is not available under either community property vesting. [CC §682.1]

A joint tenant's right of survivorship

A joint tenancy vesting adds nothing to the legal aspects of the ownership interest held in the real estate by each co-owner. Whether the interests held by the co-owners are separate property or community property, a joint tenancy vesting neither enlarges nor reduces the nature of the ownership interest.

However, a **necessary incident** of a joint tenancy vesting is the right of survivorship, legally referred to as *jus accrescendi*. The right of survivorship is a case law doctrine which is triggered by the death of one joint tenant. Thus, the joint tenancy vesting, by the incident of its right of survivorship, becomes operative only on the death of a joint tenant, at which time the right of survivorship extinguishes the deceased's interest and leaves the remaining joint tenant(s) with the entire ownership interest.

Ultimately, and on the death of all other joint tenants, the last survivor becomes the sole owner of the interest in the whole property originally owned by all the joint tenants.

Creating a joint tenancy

Although most joint tenancies are created between husband and wife, a joint tenancy can exist between persons other than a married couple. The community property vestings are only available to a husband and wife.

Also, the number of joint tenants is not limited to two, as is a married couple's ownership of community property interests. Any number of co-owners can, under one deed, take title to real estate in equal shares as joint tenants.

Traditionally, the creation of a joint tenancy requires the conveyance of *four unities*:

- **unity of title**, meaning the joint tenants take title to the real estate through the *same instrument*, usually a grant deed;
- **unity of time**, meaning the joint tenants take title at the *same time*;
- **unity of interest**, meaning the joint tenants own *equal shares* in the property; and
- **unity of possession**, meaning each joint tenant has the *right to possess* the entire property. [**Swartzbaugh** v. **Sampson** (1936) 11 CA2d 451]

The four unities traditionally required to create a joint tenancy grew out of the ancient English common law treatment of joint tenancies. More recently, the requirements for creating a joint tenancy have been codified in California.

The statute defining a joint tenancy is loosely based on the ancient unities. For example, a joint tenancy is defined as ownership by two or more persons **in equal shares**, thus incorporating the unity of interest into the statutory definition. [CC §683]

Married couple: wording the grant deed vesting

Joint tenancy: *John Doe and Jane Doe, husband and wife as joint tenants*

Community property: *John Doe and Jane Doe, husband and wife as community property*

Tenants in common: J*ohn Doe, a married man as to an undivided one-half interest, and Jane Doe, a married woman as to an undivided one-half interest, as tenants in common*

Separate property of one spouse: *John Doe, a married man as his separate property*

Inter vivos trust: *John Doe and Jane Doe, trustees of the Doe Family Trust*

Similarly, a joint tenancy must be created by a **single transfer** to all joint tenants, thus carrying over and combining the unity of title and unity of time required under common law.

A joint tenancy in real estate ownership may be created by any of the following transfers, each being a separate single conveyance, if the transfer document states the co-owners take title "as joint tenants":

- a transfer, by grant deed, quitclaim deed or assignment, from an owner of the fee, leasehold or life estate to himself and others as joint tenants;
- a transfer from co-owners vested as tenants in common to themselves as joint tenants; or
- a transfer from a husband and wife holding title as community property, tenants in common or solely, to themselves as joint tenants. [CC §683]

For the small percentage of joint tenants who are not husband and wife, typically family members or long-lived friends, a valid joint tenancy is created when all co-owners take title under the same deed as joint tenants, without stating their fractional interest in ownership.

A vesting of "community property with right of survivorship" is created on the *acceptance* by a husband and wife of a deed so vesting their acquisition of property. For a husband and wife to convert a vesting to community property with right of survivorship, they merely deed out of their present vesting (as grantor) and deed back into themselves as "husband and wife as community property with right of survivorship" (as grantee).

No requirement exists calling for consent to the vesting beyond mere *delivery* of the deed. [CC §682.1(a)]

Severing a right-of-survivorship vesting

A husband and wife are the vested owners of a parcel of real estate which is community property. The vesting provides for the right of survivorship under either a community property with right of survivorship or joint tenancy vesting.

Shortly before her death, the wife is advised the vesting with its right of survivorship means her interest in the property will automatically pass to her husband on her death. The wife wishes to distribute her interest in the property to others by her will. To do so, the wife must *terminate* the right of survivorship

by *severing* the community property with right of survivorship or joint tenancy vesting. Remember, the property retains its community property status after the severance deed is recorded.

To sever the vesting, the wife prepares and signs a deed from herself "as a joint tenant" or "as community property with right of survivorship," whichever is applicable, and then deeds it back to herself. The deed includes the statement, "This transfer is intended to sever the joint tenancy," or, in lieu of the words joint tenancy, "...community property with the right of survivorship."

The wife then **prepares a will** directing the disposition of her one-half interest in the couple's community property to someone other than her spouse on her death.

The wife dies, and her estate is probated, conveying her one-half interest in the couple's real estate as indicated by her will. The husband claims the real estate passes to him under the right of survivorship since the wife's unilateral deed to herself was ineffective to terminate the right of survivorship.

Did the wife's deed to herself terminate the right of survivorship?

Yes! Every vested co-owner has the right to *unilaterally sever* the joint tenancy or community property with right of survivorship vesting which *terminates* the right of survivorship, whether the interest in the real estate is separate or community property. A co-owner terminating the right of survivorship is not first required to give notice or seek consent from the other co-owner to sever the vesting. [**Riddle** v. **Harmon** (1980) 102 CA3d 524]

Alternatively, the wife could transfer title to herself as trustee under her revocable inter vivos trust agreement which would also avoid the probate process altogether.

Further, any transfer of a joint tenant's interest in the joint tenancy property to a third party, such as from a joint tenant parent to a child, **automatically severs** the joint tenancy.

However, a deed to oneself has only recently been recognized as a valid method for severing a joint tenancy. Historically, a joint tenant wishing to unilaterally sever the joint tenancy was required first to deed the property to a third-party "straw man." The transfer to a third party having severed the joint tenancy, the straw man would concurrently deed the property back to the former joint tenant, who would hold title as a tenant in common or as community property without the right of survivorship. [**Burke** v. **Stevens** (1968) 264 CA2d 30]

The need for a straw man was based on joint tenancy's origins in feudal law, and the ancient theory a person cannot deed property to himself. The *Riddle* court discarded this archaic and cumbersome double-deeding rule. A joint tenant is now able to sever the joint tenancy directly rather than through an elaborate legal fiction.

Riddle has since been codified, giving joint tenants the statutory right to sever joint tenancies through a unilateral deed or other written declaration. [CC §683.2]

Recording requirement for severance

Recording is necessary to terminate another joint tenant's right of survivorship. The unilateral severance (deed) of a joint tenant's interest must be either:

- recorded in the county where the property is located before the death of the severing joint tenant; or

- recorded within seven days after the joint tenant's death if executed and notarized within three days before the joint tenant's death. [CC §683.2(c)]

Also, the joint tenancy may be severed by agreement of the joint tenants. If a written agreement to sever the joint tenancy is signed by all the joint tenants, recording or notarization is not required. [CC §683.2(d)]

All the preceding rules for recording a severance deed apply fully to the severance deed of a spouse seeking to terminate the right of survivorship held under the community property vesting. [CC §682.1]

The severance of a joint tenancy terminates the right of survivorship. Without the existence of the right of survivorship, each co-owner disposes of his interest in the property on death as he wishes, such as by will or inter vivos trust, or by the severance itself.

Although a **sale** of a joint tenant's separate property interest in the real estate severs the joint tenancy, a **lease or encumbrance** of the property by a joint tenant does not.

All the procedures for severing a joint tenancy are fully available for a husband or wife to sever the community property vesting which includes the right of survivorship. [CC §682.1]

Termination on death

When ownership in property is vested as a joint tenancy, the death of a joint tenant *automatically extinguishes* the deceased joint tenant's interest in the real estate, leaving the surviving joint tenant(s) as the sole owner(s). However, the deceased joint tenant's interest in the property must be cleared from the title before the surviving joint tenants will be able to deed out, lease or encumber the property as the sole owner.

The surviving joint tenant's new ownership interest is documented by simply recording an *affidavit*, signed by anyone, declaring the death of a joint tenant who was a co-owner of the described real estate. [Calif. Probate Code §210(a)]

The interest in the property held by the deceased spouse "as community property with right of survivorship" is extinguished by the same affidavit procedure used to eliminate the interest of a joint tenant, except the surviving spouse (or representative) is the only one authorized to make the declaration. [See **first tuesday** Form 461]

The joint tenancy affidavit, which is a statement made under the penalty of perjury, includes:

- the name of the deceased joint tenant, sometimes called the *decedent*;
- a copy of the deceased joint tenant's death certificate;
- a description of the real estate affected by the joint tenant's death; and
- a statement the deceased is the person vested in title to the described property as a joint tenant. [See Form 460 accompanying this chapter]

Once the affidavit is **notarized, recorded and indexed**, anyone conducting a title search will have notice of the joint tenant's death since the deceased joint tenant is indexed as a grantor. Thus, the surviving joint tenant becomes the sole owner of the property due to the right of survivorship.

Lien or lease extinguished on death

A trust deed lien or a creditor's judgment lien secured solely by a joint tenant's interest in real estate is extinguished on the death of the joint tenant. By the right of survivorship held by the surviving joint

tenant(s), the ownership interest of the deceased joint tenant is extinguished leaving nothing remaining for the lien to encumber.

These rules of nonliability do not apply to debts of the deceased spouse under the community property vestings, with or without the right of survivorship. [CC §682.1]

Consider an *unmarried couple* who hold title to real estate as joint tenants.

A judgment creditor of one of the joint tenants seeks to execute on the judgment by foreclosing on the joint tenant's interest in the real estate.

A notice of levy is recorded and a date set for the execution sale. However, before the date of the sale, the joint tenant who is the judgment debtor dies.

The surviving joint tenant seeks to bar (or set aside) the execution sale, claiming the judgment lien only attached to the deceased joint tenant's *separate property interest* in the real estate, which was extinguished on the joint tenant's death due to the right of survivorship.

The judgment creditor claims the joint tenancy was *severed* by the recording of the levy on the deceased joint tenant's interest, terminating the right of survivorship and preserving the judgment lien.

However, until the execution sale takes place, the judgment creditor only has a lien on the joint tenant's interest in the property. Since a lien does not sever a joint tenancy and the joint tenant's interest ceases to exist on his death, the judgment creditor's lien disappears with it. [**Grothe** v. **Cortlandt Corporation** (1992) 11 CA4th 1313]

Similarly, a lease entered into by only one joint tenant is extinguished on the death of the joint tenant who executed the lease. [**Tenhet** v. **Boswell** (1976) 18 C3d 150]

Vesting alone does not transmute community property

All property acquired jointly by a married couple during the marriage, no matter how vested, is *presumed* to be community property for purposes of division on **dissolution** of the marriage. [Calif. Family Code §2581]

Should a couple having vested their co-ownership of property as joint tenants seek a divorce, the property is treated as community property.

Further, the community property presumption for married couples does not only come into play when a couple divorces. All property acquired by a couple or by either spouse during marriage is community property unless the husband and wife clearly state their contrary intention to own their individual interests in the real estate as separate property. [Fam C §760]

Thus, real estate acquired by a married couple, or by a married individual (unless received as a gift), regardless of joint tenancy, community property, or inter vivos trust vesting, is presumed to be community property under California law. [Fam C §761]

Ownership overlay

The rights under a joint tenancy vesting and community property rights held by married couples **overlap** in California law when community property is placed in a joint tenancy vesting. This overlap is a by-product of California history. The joint tenancy right of survivorship arises out of the English common

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

AFFIDAVIT OF DEATH OF JOINT TENANT

DATE:_____________, 20______, at ____, California

____,
is the deceased named in the attached certified copy of Certificate of Death and the same person named as one of the joint tenants vested as owner of the following property situated in the County of ________________________________, California, described as:

APN# _____________________

I have personal knowledge of the facts in this affidavit.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Date:_____________, 20______ ____
(Print Name) (Signature)

Date:_____________, 20______ ____
(Print Name) (Signature)

STATE OF CALIFORNIA)
COUNTY OF)
SUBSCRIBED and SWORN to before me on this _____________ day of _____________, 20______.

____
Notary Name

____
Notary Signature

(This area for official notarial seal)

law, and is called a *common law estate*, while community property is a creation of Spanish civil law, dating from the time California was a Spanish colony.

Older cases treated community property and joint tenancy as mutually exclusive, holding real estate which is community property cannot also be held in a joint tenancy vesting. Thus, a joint tenancy vesting established or transmuted the property interest of each spouse to separate property. [**Tomaier** v. **Tomaier** (1944) 23 C2d 754]

However, this *mutually exclusive* rule was eliminated in 1975.

Joint tenancy now is **merely a vesting**, used solely to avoid probate. It does not affect the underlying community or separate property character of the real estate which is vested in a husband and wife as joint tenants.

For instance, a husband and wife who take title as joint tenants do not automatically transmute their community property into separate property. A joint tenancy vesting allows a husband and wife to overcome a **rebuttable presumption** of community property based on their claim they intended the joint tenancy vesting to establish separate property interests in the real estate. Thus, the community property presumption can be rebutted by either spouse. [**Abbett Electric Corporation** v. **Storek** (1994) 22 CA4th 1460]

A similar result affecting community property occurs in bankruptcy proceedings for a joint tenancy vesting by husband and wife. The interest of each spouse vested as a joint tenant is treated in bankruptcy as separate property. Thus, a spouse's interest is not liable for community debts which were incurred solely by the other spouse. [**In re Pavich** (1996) 191 BR 838]

If the couple did not intend by the joint tenancy vesting to *transmute* their community property into separate property, but took title to their community assets as joint tenants for the sole purpose of avoiding probate — as is the case in the vast majority of joint tenancy vestings — the property remains a community asset without concern for the joint tenancy vesting. [**Estate of Wilson** (1976) 64 CA3d 786]

Thus, the nature of the underlying ownership of the property held by a husband and wife as joint tenants — separate or community — may be challenged by a third party, such as a creditor of one of the spouses seeking to reach community assets.

However, title companies will always apply the community property presumption when real estate is vested in a husband and wife, regardless of the vesting. A title company will not insure a conveyance of an interest in the couple's property, such as a trust deed encumbrance executed by only one spouse, since the signatures of both spouses are required to convey interests or impose liens on community property. [Fam C §1102]

Conveying community property

A joint tenant's ability to sell, lease or encumber the real estate depends on whether the real estate is separate or community property. When the real estate vested in joint tenancy is community property of a husband and wife, both spouses' signatures are required to execute an enforceable purchase agreement or encumbrance of the property, or to enter into a lease agreement with a term over one year. [Fam C §1102]

Thus, a sale, encumbrance or long-term lease of the community property executed by only one spouse is *voidable*, meaning the transaction may be set aside by the nonconsenting spouse. Further, an agreement

to sell community property which is entered into by only one spouse may not be enforced by the buyer through an action for specific performance.

Even an agreement by one spouse to sell only his own one-half interest in the community property may be set aside by the nonconsenting spouse, since **no interest** in community property may be conveyed, encumbered or leased without the consent of both spouses. [**Andrade Development Company** v. **Martin** (1982) 138 CA3d 330]

However, if record title to the community real estate is in the name of one spouse only, a sale, lease or encumbrance executed by the title-holding spouse alone is presumed valid if the buyer, tenant or lienholder has no knowledge of the marriage. [Fam C §1102(c)]

As always, the nonconsenting spouse may bring an action within one year of the transfer to void the transaction. [Fam C §1102(d)]

Death during divorce

The coexistence of joint tenancy and community property can lead to unintended results. The following unintended result occurs whether a joint tenancy vesting or a community property with right of survivorship vesting is used.

For example, a husband and wife own a residence, holding title as joint tenants. The wife seeks a divorce, but takes no action to *sever* the joint tenancy. Before the marriage is ordered dissolved by the court, the wife dies. The husband claims the property is now his under the joint tenancy right of survivorship.

The executor of the wife's estate claims the joint tenancy was severed when the wife filed the action to dissolve the marriage, since all property acquired by a husband and wife during the marriage is to be divided under community property principles on dissolution of the marriage, without consideration for the joint tenancy vesting. [Fam C §2581]

However, the marriage was never dissolved (severed). Without a dissolution, the joint tenancy was never severed by the court. Until the **marriage is dissolved**, the residence remains vested in the husband and wife as joint tenants. Thus, the husband's right of survivorship to the property was not terminated and the husband is entitled to sole ownership of the property.

The wife, who was seeking a divorce, obviously did not intend for her interest in the property to pass to her husband on her death. However, the wife did not effect her intentions — as her attorney should have advised her — by immediately severing the joint tenancy. Thus, the husband's right of survivorship was not terminated by conveyance or dissolution, and had to be enforced — whether the deceased's interest in the real estate was separate property or community property. [**Estate of Blair** (1988) 199 CA3d 161]

The best remedy for a spouse involved in a divorce is to unilaterally sever the joint tenancy and community property with right of survivorship vestings by deeding the spouse's interest to himself under a grant deed containing a declaration of intent to sever the joint tenancy. The revesting does not violate any injunction against conveyancing. [Fam C §2040(3)(b)]

Further, the community property interest of a spouse who deeds to oneself to sever the title and eliminate the right of survivorship remains community property. Community property cannot be transformed to separate property without the consent of both spouses or a court order.

For example, under a community property vesting with the right of survivorship or a joint tenancy vesting, the severance deed to oneself terminating the right of survivorship is not sufficient by itself to

avoid passing the property to the surviving spouse on death. A will must also be prepared or a living trust established (and vested in title to the property) naming the person intended to receive the spouse's community property interest on death. Otherwise, the property, being community property, will pass by *intestate succession* to the surviving spouse as though the severance of the vesting had never occurred. [Calif. Probate Code §13500]

However, consider another case which is identical to *Blair* in all respects, except the wife dies *after* the marriage is ordered dissolved but before the property is taken out of the joint tenancy vesting. The husband claims he is entitled to the couple's residence due to the joint tenancy right of survivorship.

However, community real estate vested in the name of the husband and wife as joint tenants becomes separate property *on dissolution* of the marriage. The community aspect of the property now no longer exists. Thus, the order dissolving the marriage severs the joint tenancy and terminates the husband's right of survivorship to the wife's interest in the property. [**In re Marriage of Hilke** (1992) 4 C4th 215]

Accordingly, the ex-wife's (now) separate property interest will be distributed under the terms of her will, or by intestate succession in the absence of a will.

Encumbering and leasing joint tenancy property

When the real estate held in a joint tenancy vesting is **separate property** — as when the joint tenants are not husband and wife or when a husband and wife in writing agree their interests are separate property — each joint tenant can sell or encumber his interest in the real estate without the consent of the other joint tenants.

Also, when the joint tenancy in real estate represents **separate property**, a joint tenant may lease out the entire property since a lease is a transfer of possession, and each joint tenant has the right to possession of the entire property. [Swartzbaugh, *supra*]

However, consider a husband and wife who own real estate which is **community property**, holding title as joint tenants. The husband enters into an agreement to lease the property for a term over one year, which the wife does not sign.

Under the joint tenancy rule, either joint tenant alone may lease the property. However, under the community property rule (which applies to property acquired during the marriage), both spouses must execute a long-term lease agreement.

This one-spouse leasing scenario is an example of the misunderstanding created by the overlay of community property rights when community property is placed in a joint tenancy vesting.

Although no case or statute addresses this set of facts, existing case law suggests the joint tenancy vesting should be viewed as controlling, thus allowing the joint-tenant husband to lease the property. Also, the doctrine of ratification would influence the result (in favor of the tenant) if the nonconsenting spouse knowingly enjoyed the benefits of the lease. [CC §2310]

Joint tenancy tax aspects

Taxwise, the main question raised for a husband and wife by a joint tenancy vesting of real estate is: What is the surviving joint tenant's **cost basis** in the property due to the death of the other joint tenant?

On the death of one spouse, the surviving spouse becomes the sole owner of the community real estate and receives a "fully" stepped-up cost basis to the property's current fair market value. [Internal Revenue Code §1014(b)(6)]

Further, the surviving spouse is entitled to a fully stepped-up basis in the community real estate regardless of whether the community property is vested as community property, as joint tenants, or in a revocable inter vivos trust. State law controls how marital property will be characterized for federal tax purposes. Federal law is unconcerned with "...the form in which title is taken." [Revenue Ruling 87-98]

By California law, all property acquired by a husband and wife during marriage is community property, regardless of the vesting, if it is managed and operated as a community asset by the couple. [Fam C §760]

Thus, the real estate is community property for federal income tax purposes, and the surviving spouse receives a fully stepped-up basis.

However, consider a wife who becomes the sole owner of a trust deed note on the death of her husband since they held the note and trust deed as joint tenants, in a living trust or in one of the community property vestings. The trust deed note is a carryback from a sale years earlier. The note amount contains profit the couple is reporting on the installment method. At the time of the husband's death, profit on the unpaid principal in the note had not yet been taxed since calculation and payment of the **tax was deferred** until principal was received on the note.

For income tax purposes, the wife seeks a stepped-up basis on the entire note to its market value on the date of her husband's death since she became the sole owner of the note and the note was community property.

The Internal Revenue Service (IRS) claims the note does not qualify for a stepped-up basis. The note contains profit from a *nonexempt sale* which is being taxed as principal is received, but has not been entirely taxed prior to death.

The wife claims the note qualifies for a stepped-up basis since the note is a community property asset she received on her husband's death.

However, the carryback note held by the community and received by the wife on her husband's death does not qualify for a step-up in basis. The note at the time of death contained profit from a sale which was reportable (recognized) and had not yet been taxed. [**Holt** v. **United States** (1997) 39 Fed. Cl. 525]

Chapter 22 Securities aspects of LLC syndication

This chapter discusses the securities risk of development and business operations in a group investment.

Exclude the economic risks of real estate

Forming a limited liability company (LLC) for real estate syndication requires an understanding of state and federal securities laws to avoid securities violations. In federal law, the classic definition of a corporate security is:

- an **investment** of money;
- a **common enterprise**, providing for mutual success or failure of the group in its investment goals; and
- an **expectation of profits** produced by the efforts of others. [**Securities and Exchange Commission** v. **W.J. Howey Co.** (1946) 328 US 293]

Thus, the formation of any group to purchase and own real estate, since it is an **investment** in a **common enterprise**, has the potential of creating a securities risk, should a *return of the investment* be based on a promise of future physical development or other change of use for the real estate acquired.

However, the mere formation of an LLC for a group to purchase and operate an existing income-producing real estate project, or hold land for profit, does not involve a securities risk — the **expectation of a return** is based on the performance of the property in the marketplace, not on the efforts of the syndicator or anyone else to produce improvements or develop a use for the property after acquisition.

Since the LLC is merely a business structure used for group ownership of a real estate investment program, a securities risk is not created by publicly offering fractional membership interests in an LLC to fund acquisition of existing assets.

Conversely, an investment group formed to develop real estate or undertake an ongoing resale marketing program or business opportunity contains securities risks. Placing the investors' capital at a **risk of loss** by the need to complete significant value-adding activities after the acquisition of the property, or by the later selection of the asset to be acquired (a blind pool) before the investment can perform in the market place, creates a corporate securities risk.

When an investment program involves a securities risk, the syndicator creating the program and soliciting investors' capital must, unless exempt, report to the appropriate government agency — the California Department of Corporations (DOC) for state securities rules, and the Securities Exchange Commission (SEC) for federal law. Some *exemptions* exist to remove investment programs containing securities risks from control under securities laws.

Failure to correctly qualify or register the sale of non-exempt corporate securities exposes the syndicator who creates the securities risk to civil and criminal liability.

A properly selected and structured investment program avoids activities, such as after-closing development, asset selection and collective coordination (pooling), which place the investors' capital at a risk of loss after closing, and thus, creates a corporate security.

Securities risk vs. existing asset

An LLC purchases a newly constructed and unoccupied apartment building. The syndicator is to serve as manager for the LLC and manage the property after closing. The LLC has the right to cancel the property management agreement with the syndicator by removing him as the manager on 30 days notice.

The investment program fails for lack of available tenants to occupy the property and provide income to pay expenses and debt.

The LLC members later claim the purchase of the complex coupled with the property management agreement created a corporate security. The members relied on the syndicator's management activities to rent the newly constructed building and create a return on the capital invested in the LLC by the members.

However, the members retained *control over the management* of the property based on their right to terminate the property management agreement and the manager by a vote of the members and replace management with readily available management in the brokerage community.

Thus, no security was created by the management agreement. Rather than placing capital at risk in reliance on the skill and effort of another to create a return on the investment, the LLC acquired a fully improved existing asset over which it retained ultimate management and control and could change management at any time. [**Fargo Partners** v. **Dain Corp**. (1976) 540 F2d 912]

Now consider a promoter who sells small parcels of agricultural land planted with citrus trees to individual investors. Under a **service agreement** attached to each purchase agreement, the promoter will care for the trees, and harvest and market the fruit. The term of the service agreement is 10 years.

The promoter operates the groves on all of the parcels sold to the investors, coordinating the ownership and operations of the parcels as a single large-scale farming operation. The promoter has the knowledge and equipment required to conduct the farming operation successfully — to **produce and sell** the crop. Each investor receives a share of the profits from the crop production based on their fractional ownership of all farm property under the service agreement, a *pooling arrangement*.

In contrast to the ownership of an apartment building in which the syndicator was employed as a manager not to produce and sell the units, but to locate tenants and rent existing units, the investment in parcels of agricultural land to operate a farming business, coordinated and operated by the promoter, contains a corporate securities risk. The investors rely entirely on the expertise of the promoter to create a return of their funds by producing and marketing a crop in cooperation with owners of other properties.

Even if an investor did cancel the service agreement with the promoter, he would not realistically be able to economically operate his parcel of land separate from the others, or readily hire another manager to coordinate the other owners and operate the parcels as a collective to produce and market crops. The economic success of the operation requires all the parcels to be operated as one, using special equipment and skills possessed by the promoter.

Thus, even though the transaction was structured as a sale of parcels of real estate combined with a service agreement, it displays the critical elements of a corporate security — a group investment, with an expectation of profits and success inextricably interwoven with the efforts of others to produce income and ultimately return the investment. [W.J. Howey Co., *supra*]

Protecting the investor

The state and federal corporate securities laws exist to protect investors who risk their capital in *asset-creating investment* schemes offered by others to give them a reasonable opportunity to realize profits on the investment.

A securities risk is created whenever:

- an investor places his funds at risk; and
- assumes a passive role with control over essential asset selection, development, pooling, or resale decisions held exclusively by the syndicator or others.

Ironically, a security is created when the only "security" for the capital placed at risk by the investor is a promise from the syndicator or others to perform a value-creating task after the close of the purchase, a task which must be completed successfully before a return of capital can be expected.

In essence, the investor has not invested in an existing asset, but in the skill of someone else to create a valuable asset in the future, after invested funds are no longer controlled by the investor. After closing, activities which create a securities risk include:

- later locating and acquiring the property;
- obtaining government approval or permits;
- further improvement of the property acquired; or
- operating a business which requires production or sales.

Thus, for a security to exist, the syndicator must undertake an ongoing investment activity which continuously places the investor's capital at risk of loss until the promised activity is completed.

Examples of securities risk activities by groups investing in real estate include:

- subdividing, improving, or reselling the real estate (dealer activities);
- operating a business on the premises acquired rather than merely managing the rental of the real estate or vacant land; and
- buying and selling to maintain a portfolio of trust deeds.

The securities laws are designed to give investors a fair chance of realizing promised investment objectives. The syndicator is held responsible for his promise to complete after-closing activities which are necessary to create a return of the investors' contributions. [**Silver Hills Country Club** v. **Sobieski** (1961) 55 C2d 811]

Controlled investments

The securities issue for the syndicate manager is to determine which investment activities include and which do not include situations which create risks triggering additional securities law protection for the investors.

The existence of a security is a matter of *substance over form*. It is the economic function of the transaction, rather than the name it bears, which determines whether a securities risk exists.

Editor's note — An exception to the substance-over-form rule is the issuance of ***stock****. Any transaction which involves the issuance or transfer of investment certificates which are formally called stock is a controlled security, regardless of the economic substance of the investment in the "stock."* [**Landreth Timber Company** v. **Landreth** (1985) 471 US 681]

For example, the citrus grove investment program in *W.J. Howey Co.* was structured as a sale of agricultural property. Each investor became the separate owner of an individual parcel of land — a situation in which normally no security is created.

However, the owners had no reasonable ability to control or operate the property and farming business they purchased. Success was entirely in the hands of the promoter to create a return of their invested funds through the coordination, production, and marketing of crops.

Next, consider a buyer who purchases a condominium unit through a real estate broker. The broker also arranges for the buyer to enter into a *rental pooling agreement* (RPA) with a management company. The broker has no connection to the management company employed in the RPA.

Under the RPA, the management company oversees operations of the entire project in which the buyer's unit is located. As managers, they distribute spendable rental income (rent minus expenses) to the owners of individual units based on their pro rata share of ownership participation in the RPA, not based on the actual performance of the units.

The RPA is a major inducement for the buyer to purchase the condominium unit, since it will enable him to locate tenants, rent and collect rental income without being personally responsible for the management of his unit. He will also share the risk of income and expenses with everyone else. The buyer plans to cover his monthly payments on the condominium out of the rental income.

Ultimately, the unit fails to produce the level of rental income the buyer expected. The buyer seeks to recover money damages from the broker, claiming the purchase of the condominium coupled with the RPA was a corporate security, since the buyer relied on the management efforts of others in the **joint operation** of several units to produce a return of his investment.

The broker claims he did not create a corporate security since the buyer was not required to enter into the RPA as part of the agreement to purchase the condominium, and the broker was not in control of the management of the property.

However, the purchase of the condominium unit coupled with the RPA was presented to the buyer as a single investment scheme. Thus, the buyer was induced to invest his funds in a *common enterprise* based on an **expectation of profits** produced by the efforts of others in a "pool and split" program — even though the broker himself was not the person responsible for coordinating the rental pooling effort.

Since the broker induced the buyer to release his funds based on a future return created by the efforts of others — the pooling and management of several separately owned properties under the RPA — a securities risk was created. [**Hocking** v. **Dubois** (9th Cir. 1989) 885 F2d 1449]

Actual and effective control

The main question in determining when a securities risk exists is whether the investors retain actual and effective control over their capital after handing it to the syndicator.

An investor may be given some nominal or insignificant role in the management of the program, such as the signing of checks when bills are to be paid. Yet, the program is a securities risk if the return of the investor's capital requires substantial reliance on others who are **uniquely positioned** to perform activities necessary to the successful completion of the promised investment activity, such as determining the inventory to be purchased for a resale business or for a farming operation.

For example, a promoter forms several general partnerships to collectively conduct a farming operation. Each partnership owns a separate portion of the farmland. The promoter runs the farming operation, cultivating, harvesting, and marketing the crops on behalf of all the general partnerships.

The operation fails to produce a return of the partners' investments. Several general partners claim the promoter violated the securities law, since the partnership interests are securities and no qualifications or permits were obtained to sell securities.

The promoter claims the partnership interests are not securities, since all investors are general partners, and thus have control over the operations of the farm property.

However, in spite of being named general partners, the individual investors have no control over operations. The success of the farming operation requires centralized management of the entire project which is comprised of several parcels owned by different investment groups and investors.

Since the various general partnerships only control portions of the operation, any individual investor has no effective control over his own property, much less the entire multiple-owner farming program. Thus, a security is created. A return of the investment depended on the efforts and expertise of the promoter to successfully manage a collective farming operation on the separately owned properties in a share and share alike investment program — a *pooling arrangement* no matter what business entity is used to structure the ownerships. [**Koch** v. **Hankins** (9th Cir. 1991) 928 F2d 1471]

For a contrasting scenario, consider a developer who acquires a large parcel of real estate for the development of a planned community. The developer sells parcels within the planned development to limited partnerships, advertising the parcels as being suitable for development as part of the planned community.

The developer does not promise to develop the parcels sold to the limited partnerships, or to produce profits for the limited partnerships based on the development of the entire project or in a pooling arrangement.

A limited partnership claims a security was created since it relied on the developer to complete the development of the planned community.

However, the limited partnership had complete control over the parcel it acquired from the developer — nothing remained to be done after acquisition, except wait for the marketplace to deliver a profit or loss.

The developer made no promise to develop the property or surrounding parcels, or distribute profits from his operations or from others to the limited partnership. Thus, no securities risk was created — the transaction was merely a sale of real estate to the limited partnership to hold for a profit or later development as it saw fit. [**De Luz Ranchos Investment, Ltd.** v. **Coldwell Banker & Company** (9th Cir. 1979) 608 F2d 1297]

Risk capital

State and federal courts apply slightly different tests to determine when a controlled security exists in an investment program. In California, courts apply the *risk capital test* to determine whether a transaction requires securities law protection.

The main difference between the state and federal tests revolves around the element of the *expectation of a profit* on the investment. For a security to exist under the federal test, the investors must be induced to join the program by a promise of profit on their capital investment.

The California test, on the other hand, only requires that the investors' capital be placed at risk in an activity controlled by the securities laws, whether or not a profit is expected or intended. Thus, the California securities laws are further-reaching and covers more investment conduct than federal securities laws.

The California rule is the better rule since a syndicator's mere promise of future profits does not create a securities risk.

For example, a developer sells investors memberships in a yet-to-be-built country club. Later, when the developer fails to complete construction of the county club, the investors claim the developer violated California securities laws since the club memberships sold were unqualified securities.

The developer claims the country club memberships are not controlled by California securities laws since the memberships merely provide for personal recreation, and involve no expectation of a profit.

However, unlike federal securities law, an expectation of profit is not of concern to the California securities law. The sale of memberships was a security, since the investors risked their capital on a "yet-to-be-built" project, relying on the developer to complete the construction of the country club after the members released their investment funds to acquire the property. [Silver Hills Country Club, *supra*]

Also, to avoid becoming a security under California's risk capital test, the **selection** of specific real estate for investment must preexist the investment of funds. And then, the only business conducted after closing is either the location of tenants and rental of the property, or the ultimate resale of the unaltered property at a profit.

If, on closing a purchase escrow, the investor receives the full value of his investment in the form of a fixed asset, such as a share in the ownership of existing real estate, no security is created. The investor's capital is no more at risk than had he purchased the asset outright. [**Hamilton Jewelers** v. **Department of Corporations** (1974) 37 CA3d 330]

For example, a syndicator locates the real estate he decides to syndicate. A detailed investment circular is prepared, stating the real estate will not be developed or improved, but simply owned and operated for what it is — a rental income property.

Since investors solicited by the syndicator know they will receive an existing fixed asset for their money which will not be altered after acquisition, their capital is not subject to a securities risk — only the typical economic risks of locating tenants and incurring expenses in the rental marketplace.

All money invested in real estate is to some extent at risk, due to fluctuating property values, economic conditions, acts of God, and so on. However, marketplace risks merely affect the level of income, profit or loss, and income, profits (or loss) are not the concern of California's securities laws.

Exemptions when securities risks exist

A large number of investments which are securities are exempted by statute from control under the securities laws.

Investment programs offered by banks and savings and loans (S & Ls) are exempt from securities laws, as are non-public offerings.

The non-public offering exemption is the most useful exemption for syndicators putting together investment programs which include securities risks. The non-public offering exemption, called the *35-or-less interrelationship rule*, applies if:

- the investors do not number more than 35 (husband and wife counting as one);
- all investors have a pre-existing business or personal relationship with the syndicator;
- the investors will not resell or distribute the interests they acquire; and
- the solicitation of investors does not involve public advertising. [Calif. Corporations Code §25102(f)]

Thus, even if an investment program does contain securities risks, the syndicator need not be concerned as long as his program meets the requirements for a non-public offering.

Disclosure of securities and the statute of limitations

Consider a syndicator who creates a **non-exempt security** in his investment program, and does not obtain a permit or register the sale of the investment program with the DOC or SEC. Any investor in the program may recover the full amount of his investment from the syndicator, plus 10% interest from the date of investment, minus any distributions the investor has received. [Corp C §25503]

However, the investor's recovery of his investment under California securities laws is subject to a statute of limitations. An action to recover the investor's funds must be commenced within the sooner of:

- two years after the date of the securities violation (i.e., the investment in a security without a permit); or
- one year after the investor's discovery of the violation. [Corp C §25507]

If the syndicator, as part of his investment memorandum, discloses securities permits have not been obtained, the investor will be aware of the potential violation from the beginning, and will be subject to the one-year statute of limitations.

Until the one-year limitations period expires, the investor may unilaterally withdraw his investment funds at any time (plus interest, minus distribution of earnings). However, when the year is up, the syndicator is safe from investor claims for securities violations and civil money damages.

Realistically, if an investor is willing to contribute his funds to a real estate syndication in the first place, he is unlikely to withdraw and file an action within one year. Real estate investments are unlikely to go sour within one year.

Thus, even if the syndicator is certain he is not creating a security, a disclosure that no permit exists is a precaution against a mistaken belief.

Chapter 23 Automatic and declared homesteads

This chapter compares the equity protection available to a homeowner against creditors under a recorded declaration of homestead and the automatic homestead.

Equity protection against judgment

A homeowner is sued by a creditor for money owed on a debt. The debt is not secured by the homeowner's residence.

A **money judgment** is awarded to the creditor who becomes a *judgment creditor*. The homeowner becomes a *judgment debtor*.

An **abstract** of the judgment is recorded by the creditor in the county where the homeowner's residence is located.

Can the homeowner now prevent the recorded abstract from attaching as a lien against the title to his home?

No! However, the type of homestead the homeowner claims — there are two — and the amount of the homestead exemption he qualifies for — there are three — determines the homeowner's ability to:

- bar the judgment creditor from **forcing a sale** of the home to satisfy the judgment; or
- **voluntarily sell** the home and buy another home with the homestead amount he has in his equity.

The homestead interest in title

A **homestead** is a dollar amount of the equity held by a homeowner in his dwelling with priority on title over most judgment liens and some government liens.

Two types of homestead procedures are available to California homeowners to establish the homestead equity in their home that is exempt from execution by most involuntary lienholders:

- the *declaration of homestead*, which is recorded [Calif. Code of Civil Procedure §704.920]; and
- the *automatic homestead*, also called a *statutory homestead exemption*. [CCP §704.720]

While the automatic homestead is a dollar amount of equity protection given to all homeowners in California, a homeowner **must record** a declaration of homestead to receive the additional resale benefits available under the homestead laws.

Both the declared and automatic homestead amounts do not interfere with and remain junior to:

- **voluntary liens** placed on the property by the homeowner, such as trust deeds; or
- **involuntary liens** given priority to the homestead exemption under public policy legislation.

Involuntary liens and encumbrances which have priority and can be enforced as senior to the amount of the homestead exemption include mechanic's (contractor's) and vendor's (seller's) liens, homeowners' association (HOA) assessments, judgments for alimony or child support, real estate taxes and Internal Revenue Service (IRS) liens.

Involuntary liens which are subordinate and junior to the homestead amount include:

- Franchise Tax Board (FTB) personal income tax liens;
- Medi-Cal liens; and
- judgment creditor's liens.

Declaring a homestead

The recorded homestead declaration includes:

- the name of the homeowner declaring the homestead;
- a description of the property being homesteaded; and
- a statement declaring the real estate to be the principal dwelling of the homeowner in which he resides on the date the homestead is recorded. [CCP §704.930(a); see Form 448 accompanying this chapter]

The declaration must be signed, notarized and recorded to take effect. [CCP §704.930]

The homestead declaration may be **signed and recorded** by any one of several individuals, including:

- the owner of the homestead;
- the owner's spouse; or
- the guardian, conservator, attorney in fact, or a person otherwise authorized to act for the owner or the owner's spouse. [CCP §704.930(b)]

An individual's personal residence which is vested in a revocable inter vivos (living) trust, or other type of title holding arrangement established for the benefit of the homeowner, can also be declared a homestead by anyone who has an interest in the property and resides there. [**Fisch, Spiegler, Ginsburg & Ladner** v. **Appel** (1992) 10 CA4th 1810]

Further, a declaration of homestead in no way restricts the homeowner's ability to voluntarily convey or encumber his homesteaded property. [CCP §704.940]

A recorded homestead will not appear in credit reports or impact the homeowner's credit reputation or ability to borrow. Title companies disregard recorded homestead declarations, except in litigation guarantee policies.

Automatic and declared homesteads

An automatic homestead is always available on the principal dwelling occupied by the homeowner or his spouse when:

- a judgment creditor's abstract is recorded against the homeowner and attaches as a lien on the property; and
- the occupancy continues until a court determines the dwelling is a homestead. [CCP §704.710(c)]

The **automatic homestead exemption** from the equity applies to a real estate dwelling (and its outbuildings), a mobilehome, a condominium, a planned development, a stock cooperative or a community apartment project together with the land they rest on, as well as a houseboat or other waterborne vessel. [CCP §704.710(a)]

However, a **recorded declaration** of homestead applies only to real estate dwellings. Thus, mobilehomes not established as real estate and houseboats are not protected by a recorded homestead, only by

the automatic homestead. Also, a leasehold interest in real estate with an unexpired term of less than two years is not protected by a recorded homestead declaration. [CCP §704.910(c)]

The homesteaded real estate

As long as the homeowner claiming the exemption actually uses the homesteaded property as the principal residence for himself and his family, the type of real estate qualifying for a homestead includes:

- two five-room flats [**Viotti** v. **Giomi** (1964) 230 CA2d 730];
- an 18-unit apartment building where the owner occupies only one unit [**Phelps** v. **Loop** (1944) 64 CA2d 332]; and
- 523 acres of rural land with a house and water rights for the land. [**Payne** v. **Cummings** (1905) 146 C 426]

Homeowners qualify for one of three dollar amounts of **net equity** homestead protection:

- a $50,000 equity for a homeowner with no dependents;
- a $75,000 equity for a head of household; or
- a $150,000 equity for the aged or disabled. [CCP §704.730]

Amount of equity protected

Whichever amount of home equity protection a homeowner qualifies for, the amount is protected when using either the automatic or recorded homestead.

An individual homeowner with **no dependents** other than himself qualifies for the $50,000 homestead exemption. [CCP §704.730(a)(1)]

As **head of a household**, a homeowner qualifies for the $75,000 homestead exemption by providing support for a spouse, dependent children, grandchildren, parents, grandparents or in-laws. [CCP §704.730(a)(2)]

A homeowner qualifies for the $150,000 homestead exemption if the homeowner or the spouse of the homeowner is:

- 65 or older;
- physically or mentally disabled; or
- 55 or older with an annual income of less than $15,000 or, if married, a combined gross annual income of not more than $20,000. [CCP §704.730(a)(3)]

Both a husband and a wife may be the declared homestead owners in the same homestead declaration when both husband and wife own an interest in the property. [CCP §704.930(a)(1)]

However, a couple's combined homestead exemption cannot exceed the amount for a head of household ($75,000), unless one or both qualify as an aged or disabled person ($150,000). [CCP §704.730(b)]

Further, if both spouses are entitled to a homestead exemption, the homestead proceeds will be apportioned to each spouse according to their proportionate ownership interest in the homestead. [CCP §704.730(b)]

Abstract avoids homestead increases

As the legislature increases the amount of the homestead exemptions, the homeowner need not record a new declaration — the increased amount applies to the old declaration.

However, if a lien is recorded prior to the increase in the amount of the exemption, the amount of equity protected from the attachment is the homestead amount that was available when the lien was recorded, whether the homeowner is claiming an automatic or declared homestead.

Thus, inflation or appreciation in the value of the residence may create an equity large enough to exceed the homestead amount and provide some recovery for a judgment creditor. [**Berhanu** v. **Metzger** (1992) 12 CA4th 445]

Combating a creditor's sale

A judgment creditor with a recorded abstract can force the sale of an owner's home to collect on a money judgment if a **court first confirms** the owner's net equity in his home exceeds the amount of his homestead exemption — whether the homestead is automatic or by recorded declaration. [CCP §704.740(a)]

For example, the head of a household owes $85,000 on trust deed loans encumbering his home. An unsecured creditor is awarded a money judgment against the homeowner and an abstract is recorded, attaching as a lien on the title of the property.

But before the creditor can begin judicial proceedings against the equity in the home to collect on the judgment, the home needs a **net value** in excess of $160,000 — the $85,000 owed on the existing trust deeds plus the $75,000 homestead exemption.

A home with a **net equity** (after sale costs) of less than the homestead amount leaves nothing for the creditor to sell to collect on the judgment.

Forced sale order

However, the sale of the homesteaded dwelling can be forced by a creditor if an equity exists beyond the amount of the homestead. The creditor must first **file an application** for a judicially ordered sale, called an *execution sale*, stating under oath:

- a description of the property;
- whether a declared homestead has been recorded on the property;
- the names of the person or persons who claim the homestead;
- the amount of the homestead; and
- the amounts of all liens and encumbrances recorded on the property and the names and addresses of the lienholders. [CCP §704.760]

If the homestead is a declared homestead and the creditor challenges the **validity** of the declaration, the creditor must prove the property does not qualify for a homestead.

However, if the homeowner has not recorded a declaration of homestead on the property, the homeowner must demonstrate that the property qualifies for the automatic homestead exemption. [CCP §704.780(a)(1)]

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street
Address

City &
State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

DECLARATION OF HOMESTEAD

DATE:_____________, 20______, at ____, California

Items left blank or unchecked are not applicable.

1. The name of the owner or owners of the real estate subject to this declared homestead:

____

enter the name of the individual entitled to the Homestead exemption

2. The declared homestead regards real estate situated in the City of ____________________________________, County of ___________________________________, California, described as:

2.1 The property is more commonly referred to as:

____

enter the street address and the city

3. The declared homestead is the principal dwelling and now resided in as the residence of:

☐ A declared owner of the homestead;

☐ The declared owners of the homestead; or

☐ The spouse of the declared owner of the homestead.

4. I execute this declaration of homestead as:

☐ a declared homestead owner.

☐ the spouse of the declared homestead owner.

☐ the guardian or conservator of the person or estate of the:

  ☐ declared homestead onwner; of

  ☐ spouse of the declared homestead owner.

☐ an attorney in fact for the:

  ☐ declared homestead owner; or

  ☐ spouse of the declared homestead owner.

4.1 As a guardian, conservator or attorney in fact, acting on behalf of the declared homestead owner or the spouse of the declared homestead owner, I am authorized to execute this declaration under the authority vested in me by ______________________________
enter identification of the source of your authority

5. The facts stated above are known to me to be true as of my own personal knowledge.

Date:_____________, 20______ ____
(Print Name) (Signature)

Date:_____________, 20______ ____
(Print Name) (Signature)

STATE OF CALIFORNIA)
COUNTY OF_______________________________)
On ________________________________ before me,
____
(name of notary public)
personally appeared ____________________________
____,
(name of principal)
personally known to me (or proved to me on the basis of satisfactory evidence) to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

WITNESS my hand and official seal.

Signature: ________________________________
(Signature of notary public)

(This area for official notarial seal)

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If the execution sale of the property is ordered and the bids received at the sale are insufficient to satisfy the senior liens and encumbrances, plus the homestead amount and the sales costs, the dwelling will not be ordered sold. [CCP §704.800(a)]

Also, the bid must exceed **90%** of the fair market value of the property as set by the court. [CCP §704.800(b)]

A real estate appraiser is often appointed by the court to assist in determining the fair market value of the dwelling. [CCP §704.780(d)]

If the property is jointly owned by the judgment debtor/homeowner and another person as joint tenants or tenants in common, only the judgment debtor's interest in the property will be sold. [CCP §704.820(a)]

The proceeds from an execution sale of the dwelling are disbursed in the following order:

- pay all senior liens and encumbrances on the property;
- disburse the amount of the homestead equity to the homeowner;
- cover the costs of the sale;
- pay the judgment creditor's court costs;
- pay the amount due the creditor from the judgment; and
- any remaining proceeds go to the homeowner. [CCP §704.850]

"Drawing down" the homestead amount

Now consider a homeowner who records a declaration of homestead on his principal residence which is encumbered by a trust deed. A judgment lien creditor obtains a money judgment against the homeowner and records an abstract of judgment.

Later, the homeowner records a second trust deed on the residence to secure another loan for an amount less than the homestead exemption.

The homeowner defaults on the first trust deed loan, and the first trust deed holder forecloses on the residence. The residence is sold at a trustee's sale on a bid in excess of the amount owed to the first trust deed holder.

The judgment lien creditor claims he is entitled to the excess funds since the judgment lien is prior in time to the second trust deed.

The second trust deed holder claims he is entitled to the remaining funds since the second trust deed lien is a voluntary encumbrance which entitles him to first recover against funds due the homeowner under the homestead exemption.

Is the second trust deed holder entitled to the excess funds?

Yes! The second trust deed holder is entitled to payment from the funds remaining after satisfaction of the first trust deed debt since the judgment creditor's lien is subordinate to the homestead exemption and the amount of the homestead exemption held by the homeowner was voluntarily encumbered by the second trust deed lien. [**Smith** v. **James A. Merrill, Inc.** (1998) 64 CA4th 94]

Editor's note — An abstract of judgment, when recorded, attaches to the principal residence as a lien. A lien attaches on its recording, not when an equity position exists to provide a recoverable amount of money.

Automatic homestead

Although the automatic homestead exempts some or all of the equity in a homeowner's principal residence against money judgments obtained by the homeowner's creditors, it is merely a **shield** raised by the homeowner to defend the equity in his house against the creditor's involuntary (forced) sale.

For example, a homeowner claims his automatic exemption and receives funds in the amount of the homestead equity from a creditor's forced sale of the home. The homestead funds are protected from the creditor's attachment during a six-month reinvestment period. Further, an automatic homestead exemption is provided on the replacement residence. [CCP §704.720(b)]

Editor's note — Although the proceeds are protected from attachment by the creditor's lien for the six-month reinvestment period, it will not prevent the lien from attaching to new property (subject to the homestead exemption) the instant title is transferred into the buyer's name — if the property purchased is in the same county where the lien is recorded.

Thus, the homeowner/debtor looking to purchase a replacement home in the same county with his protected funds will not likely be able to get title insurance for a new loan. Title companies will not make a determination as to whether an exemption on the new residence is valid. Also, the abstract lien will attach to the property as a lien senior in time to the new lender's trust deed, unless it is a carryback.

The solution to the intervening (judgment) lien is to purchase property either subject to an existing trust deed or by creating a carryback trust deed. Carryback trust deeds have priority over any lien attaching to the title when the buyer takes title, unless the carryback note is specifically subordinated to the previously recorded abstract of judgment. [Calif. Civil Code §2898]

With the automatic homestead exemption, a homeowner who **voluntarily sells** his residence while title is clouded by a creditor's lien leaves the sales proceeds unprotected. Not so with a recorded declaration of homestead.

The exemption in bankruptcy

For an individual who files a bankruptcy petition, any sale of the individual's home during the bankruptcy, whether voluntary or court-ordered, is considered a forced sale entitled to the automatic homestead exemption. Thus, a bankruptcy petitioner who voluntarily sells his home (even against the bankruptcy court's order) is still entitled to an automatic homestead exemption on the proceeds of the sale. [**In re Reed** (9th Cir. 1991) 940 F2d 1317]

Now consider a homeowner whose home is being foreclosed on by the first trust deed lender. The homeowner did not file a declaration of homestead prior to the recording of a judgment lien against the property. At the trustee's sale, a bid in excess of the loan leaves funds to be disbursed to the junior lien (the judgment creditor), since a recorded abstract of judgment against the homeowner exists.

Since foreclosure under a power-of-sale provision is a **voluntary sale** by private agreement and not a forced sale which triggers the automatic homestead exemption, the automatic homestead exemption does not then protect the homeowner's equity on a foreclosure sale of the residence. Thus, the homeowner whose home is lost to foreclosure exposes any excess proceeds from the trustee's sale to the creditor's lien. [**Spencer** v. **Lowery** (1991) 235 CA3d 1636]

Editor's note — The homeowner losing his home to foreclosure will receive his automatic homestead exemption if he files a bankruptcy petition before the foreclosure is completed. In a bankruptcy proceeding, all sales are considered forced sales. [In re Reed, supra*]*

Also, the creditor can simply wait for years until the equity in the home increases and exceeds the amount of the homestead exemption, and *then* begin an execution sale. Thus, the homeowner who relies solely on the automatic homestead exemption to protect his equity is imprisoned in his own home — he cannot voluntarily sell and avoid the judgment lien unless he files a bankruptcy petition.

Although a sufficient net equity may not exist to allow the judgment creditor to force a sale of the home, the homeowner may not use a quiet title action based on an automatic homestead exemption to remove the lien — unlike a declared homestead.

Declared homestead allows resale

A recorded declaration of homestead, in contrast to an automatic homestead exemption, allows a California homeowner to take the offensive against his creditors, armed with a **sword**. The declaration allows the homeowner to use a quiet title action to **sever the liens** attached to his title.

Unlike the automatic homestead exemption, judgment liens do not attach to the exempt homestead amount under a declared homestead — if the homestead declaration is recorded prior to the recording of the abstract of judgment. [CCP §704.950(a)]

But judgment liens do attach to any equity exceeding the amount of the declared homestead exemption and all liens and encumbrances on the declared homestead at the time the abstract of judgment is recorded. [CCP §704.950(c)]

Priority of the declaration can be accomplished by the homeowner with a little prior planning. While it takes a creditor several months to obtain and record a judgment, a declaration of homestead can be prepared and recorded on forms readily available in a matter of minutes. [See Form 448]

Once recorded, a declaration of homestead lasts until:

- the homestead owner records a declaration of abandonment of the homestead; or
- the homestead owner records a new declaration of homestead on another residence. [CCP §§704.980; 704.990]

If a homeowner whose title is clouded with a creditor's lien wishes to sell his declared homestead, the homeowner may either:

- negotiate a release of the lien with the creditor; or
- clear title to the home through a quiet title action.

Clearing title

A **quiet title** action determines the priority of the creditor's lien and the recorded homestead on the title. If the homeowner demonstrates the homestead declaration is valid and prior to the lien, the title will be cleared of the lien, provided no equity remains after the homestead amount. [Viotti, *supra*]

Creditors junior to a declared homestead where no excess equity exists realize their futility in litigation and are receptive to a negotiated release. Consequently, the homeowner can usually "buy" a partial (or full) release from the creditor — typically for less than the costs of a quiet title action.

After title is cleared and the homeowner sells, he has six months to reinvest the homestead proceeds in another home. If the proceeds are reinvested in a new residence within six months, the new residence may then be declared a homestead by recording a homestead declaration within six months after the purchase.

When the homeowner records a new homestead declaration on his replacement property, the recording *relates back* to the time the prior homestead was recorded, leaving no gap for the creditor's lien to gain priority over the homestead declaration on the new residence. [CCP §704.960]

If the homestead equity exemption has increased after the creditor recorded his abstract, the amount of exemption the property owner is entitled to in his **new residence** is the amount that was in effect when the abstract of judgment was recorded — not the current amount.

However, if after six months the homeowner has not invested the proceeds of the sale in a new homestead, and the proceeds are still in the State of California, the proceeds of the homestead sale can be attached by the creditor.

An alternative to vesting title in the judgment debtor's name is to use a title holding arrangement, such as a corporate trustee or a limited liability company (LLC) created by the homeowner to hold title. Thus, the abstract against the homeowner will not attach to the title.

Chapter 24 — Encroachments — crossing the line

This chapter discusses the rights of neighboring owners of real estate when improvements on one owner's property encroach on the property of another.

Boundaries violated and hardships balanced

Shortly after his purchase of an unimproved parcel of real estate, the owner discovers the garage on his neighbor's property extends two feet over the boundary line onto his property, called an *encroachment*.

The owner demands the neighbor remove the encroachment. When the neighbor refuses, the owner seeks to compel the neighbor's removal of the portion of the garage which encroaches on his property.

The neighbor claims the owner is not entitled to a removal of the improvement since:

- the encroachment was unknown and unintentional;
- the square footage of the owner's property affected by the encroachment is minor; and
- the cost to remove the garage would far exceed the monetary loss to the owner if the encroachment were allowed to continue.

Can the owner obtain a court order forcing the removal of the encroaching garage, called an *injunction*?

No! The encroachment is unintentional and minor in its effect on the burdened owner. Thus, the burden to the owner does not justify ordering the neighbor to undertake an expensive reconstruction activity.

Instead, the owner is awarded **money damages** representing the rental value for the lost use of his property, and the neighbor is granted an **easement** over the owner's property for the life of the garage. [**Christensen** v. **Tucker** (1952) 114 CA2d 554]

For the neighbor to be allowed to maintain the encroachment, he has to act in good faith when building the improvements, i.e., without knowledge the improvements encroached on the owner's property. If the neighbor had not constructed the improvements in good faith, the owner would be entitled to an injunction forcing the removal of the encroaching structure no matter how minor the encroachment.

Also, for the owner to recover money damages for the encroachment, he has to act within the three-year period of the *statute of limitations*. If the owner delays too long in making his claim, the encroaching neighbor would earn the right to maintain the encroachment without paying any damages at all.

Even if a new owner of a property burdened by an encroachment seeks an injunction or money damages from the neighbor immediately after acquiring the property, his action can be barred by the statute of limitations. The limitations period does not run from the discovery of the encroachment or the acquisition of the property, but from the creation date of the encroachment.

Of course, the buyer could recover losses from the seller caused by the seller's failure to disclose the existence of a known encroachment. The loss would be based on the diminished value of the property and the excess purchase price paid.

Encroachment, trespass and nuisance

An *encroachment* is an improvement on real estate, such as a building, fence, driveway or tree, which extends onto real estate belonging to another person without his consent.

Encroachment is closely related to *trespass*, *nuisance* and *boundary disputes*. All involve an interference with another person's property rights.

Any encroachment qualifies as a *nuisance*, be it a permanent or continuing nuisance, since nuisance is broadly defined as any obstruction of another's use and enjoyment of his real estate.

An encroachment is also a *trespass* when it actually rests on the ground of the neighbor's property.

However, the names used for an interference are unimportant. One way or another, an owner is entitled to recover for an unauthorized interference with his property rights.

Rights affected

It is not only the fee owner of real estate who can seek to stop an encroachment. Any person holding rights in real estate may protect those rights against outside interference. Thus, the rights affected by an encroachment can include:

- leasehold interests [**Brown Derby Hollywood Corporation** v. **Hatton** (1964) 61 C2d 855];
- deed restrictions, such as limitations on the height of improvements [**Seligman** v. **Tucker** (1970) 6 CA3d 691];
- setback requirements [**Morgan** v. **Veach** (1943) 59 CA2d 682];
- easements [**City of Dunsmuir** v. **Silva** (1957) 154 CA2d 825]; and
- prescriptive easements. [**Warsaw** v. **Chicago Metallic Ceilings, Inc.** (1984) 35 C3d 564]

For instance, an owner uses a strip of his neighbor's property for access to a commercial building located on the owner's property. After the owner uses the strip for more than five years, the neighbor constructs a warehouse on the strip of land, restricting the owner's access to his building.

However, the owner's use of the strip of his neighbor's land matured into an easement by prescription. Thus, the owner is able to obtain an injunction against the warehouse improvements as they encroach on his easement rights. [Warsaw, *supra*]

Drawing the line

The existence of an encroachment is easily determined. All that is needed is a survey to locate the property line. If an improvement on one parcel extends over the line onto an adjacent parcel, it is an encroachment.

Occasionally, neighboring owners disputing the existence of an encroachment rely on contradictory surveys to establish the property line. If the owners cannot agree on the location of the property line, the boundary dispute must be resolved before any remedy for the encroachment — if one exists — can be granted.

The resolution of the boundary dispute frequently amounts to no more than a court determining which of the surveys is more accurate. [**Iacovitti** v. **Fardin** (1954) 127 CA2d 348]

However, where the boundary is marked by a physical structure, such as a fence or a row of trees, a survey is not always to be relied on.

For instance, a common boundary line marked by a fence or other structure is not located on the recorded description of the lot line. Both neighbors treat the fence as the boundary for a number of years. The agreed-to location of the property line is the boundary, regardless of deeds and surveys to the contrary.

Once an encroachment has been determined, the remedies available to the owner include:

- an *injunction* ordering the removal of the encroaching structure; and
- *money damages* for the diminished value of the property.

Balancing the hardships

An owner is entitled to terminate or prevent an unauthorized intrusion onto his real estate. However, when a building or other substantial improvement encroaches on an owner's property, the neighbor's cost of removing the encroachment may far exceed the damage inflicted on the owner burdened by the encroachment.

Thus, the encroachment is allowed to continue and the owner is awarded money damages for the lost use of his property, called *balancing hardships* or *balancing equities.*

The conditions for balancing equities — i.e., merely granting money damages and allowing an encroachment to continue — are:

- the owner of the property affected by the encroachment must not suffer an **irreparable injury** due to the continued existence of the encroachment;
- the neighbor who owns the encroaching structure must have acted innocently and in **good faith**; and
- the **cost** to the neighbor of removing the encroachment must greatly exceed the damage done to the owner. [Christensen, *supra*]

For instance, a neighbor's residence is located close to the property line. The eaves of the house and a bay window hang out over the line. The encroaching portions of the structure can be removed without great expense or loss of value.

The owner demands the removal of the encroaching structures.

The neighbor claims removal is not appropriate since the encroachment is minimal.

However, since the encroachment is minimal and the cost of removing it is small, the encroaching portion of the residence must be removed — tipping the balance in favor of eliminating the encroachment. [**Harland** v. **Noto** (1951) 105 CA2d 740]

An encroachment need not be removed if removal would adversely affect a large segment of the public.

For example, a reservoir constructed by a water company encroaches on an owner's property. The owner seeks to remove the encroachment. However, the encroaching reservoir may remain partly because the reservoir supplies water to over 500 homes. [**Ukhtomski** v. **Tioga Mutual Water Co.** (1936) 12 CA2d 726]

Good faith and innocence

The *good faith* of a neighbor who constructs improvements which encroach on the land of another must exist before any balancing of the hardship of removal or remaining can take place.

The good faith requirement prevents an intentional exploitation of the balancing hardships rule.

For example, an unimproved parcel of real estate is subject to setback requirements. The owner begins building a residence on the property.

Soon after construction commences, the owner's neighbor notices the residence is being constructed within the setback — too close to the property line. The owner is informed he is violating the setback requirements. The neighbor also threatens legal action unless the owner complies with the setback requirements.

However, the owner does not cease work on the residence. He completes the construction knowing the improvements violate the setback requirements. The neighbor seeks to enforce the setback requirements by forcing the removal of the structure from within the setback.

The cost to the owner of removing the residence far exceeds the damage to the neighbor.

However, the owner built the residence with full knowledge of both the setback violation and the neighbor's objection. Thus, the owner did not complete the construction in good faith and the portion of the structure within the setback must be removed. Had the owner innocently violated the setback requirements, the removal request would probably be denied. [Morgan, *supra*]

The encroachment easement

When the continuance of an encroachment on the owner's property is allowed, the encroaching neighbor is granted an *equitable easement* to maintain the improvement on the owner's property. Further, the neighbor must compensate the owner for the rental value of the lost use of his property. The easement lasts for the lifetime of the encroachment.

To resolve one case, the encroaching neighbor sought fee title to the portion of the property covered by his encroachment. However, to grant title would be excessive. Instead, an easement is granted since an easement is sufficient to protect the neighbor's right to maintain the encroaching improvements and avoid lot line adjustment laws. [Christensen, *supra*]

Limitations and delay

Normally, an owner seeking to terminate an encroachment or recover money damages is subject to a three-year statute of limitations running from the commencement of the encroachment. [**Bertram** v. **Orlando** (1951) 102 CA2d 506]

The limitations period for an encroachment is the same as for a *permanent nuisance* since the damage to the owner is complete and certain as soon as the encroachment is created.

The **creation date** of the encroachment is the critical date. Whether or not an owner has knowledge an encroachment exists does not affect the statute of limitations. The limitations period runs from the creation of the encroachment, not its discovery. [**Castelletto** v. **Bendon** (1961) 193 CA2d 64]

However, in the rare case where damage resulting from an encroachment is progressive over time, the three-year statute of limitations does not apply from the date of creation.

For instance, an owner's building is damaged when a neighbor's building leans on it, due to a poorly compacted fill. The degree of the tilt, and the resulting damage, increases over time.

More than three years after the damage commences, the owner seeks to recover his monetary losses from the neighbor. The neighbor claims the owner is barred from recovering damages by the running of the three-year limitations period.

However, the intrusion on the owner's building is continuous and progressive — a further intrusion. As with a **continuing nuisance**, a new claim accrues each time the loss increases. Thus, while the three-year statute of limitations does apply, it does not begin to run on the commencement of the encroachment, but runs from the date of the last increase in damage from the *progressively increasing* encroachment. [**Kafka** v. **Bozio** (1923) 191 C 746]

In addition to barring relief due to the statute of limitations, an action seeking money damages or an injunction against an encroachment can be barred by the equitable doctrine of *laches*, also called *prejudicial delay* or *detrimental reliance*.

A property owner loses his right to enforce a removal of an encroachment or recover money against the encroaching neighbor if the owner delays in making the claim causing the neighbor to rely on the owner's acquiescence to his detriment.

For example, if an owner discovers his neighbor is constructing a potential encroachment, but refrains from saying anything or taking any action until the construction is completed, he can be barred from enforcing its removal. The encroaching neighbor has relied on the owner's acquiescence in undertaking and completing the construction. [**Rankin** v. **De Bare** (1928) 205 C 639]

Finally, an owner who allows a known encroachment on his property to continue for over five years risks losing property rights through a prescriptive easement or adverse possession since the adverse use of the owner's property by the encroaching neighbor is known to the owner and continuous.

Thus, an owner must act promptly to enforce his right to remove the encroachment or receive compensation for lost value when a neighbor's improvements encroach on his property.

Chapter 25 — Other amounts due under 3-day notices

This chapter discusses the inclusion of amounts due the landlord other than "rent" in a 3-day notice to pay rent or quit.

Know what the judge will allow

A lease between a landlord and his tenant contains a rent provision with a clause calling for the **accrual of interest** from the due date on any amount of rent which becomes delinquent, called a *late payment clause*.

The tenant fails to pay rent when due or before it becomes delinquent. The landlord then prepares a 3-day notice to pay rent or quit and serves the notice on the tenant. [See **first tuesday** Form 575]

The 3-day notice itemizes the amounts of delinquent rent and daily interest accrued which are due and unpaid on the date the notice is prepared.

The tenant fails to pay or quit during the 3-day period. The landlord files an unlawful detainer (UD) action asking the court to order the removal of the tenant from possession.

At the UD hearing, the tenant claims the landlord cannot terminate his possession of the premises under the 3-day notice since the notice demands payment of an amount which is greater than the **rent due** under the lease, and thus is defective as the demand includes *other amounts due* the landlord.

May the 3-day notice include amounts due under monetary provisions in the lease in addition to "technical rent"?

Yes! **Amounts due** under rent provisions in the lease or rental agreement which may be demanded in the 3-day notice to pay or quit are not limited to the scheduled amount of periodic rent which is delinquent.

While the notice to pay may not be served until rent is delinquent, the notice itself is limited to stating the *total amount which is due*, not only the amount of rent due. Thus, the notice may include all sums of money which are **due and unpaid** under the lease or rental agreement at the time the notice is served, including the delinquent rent. [**Canal-Randolph Anaheim, Inc.** v. **Moore** (1978) 78 CA3d 477]

Examples of amounts due periodically under a lease or rental agreement, in addition to scheduled rent, include:

- common area maintenance charges (CAMs);
- association charges;
- pro rata insurance premiums, property taxes and assessments;
- late payment and bad check charges;
- expenses incurred by the landlord to cure waste or failure to maintain the property, called *future advances*; and
- other amounts of money properly due as compensation or reimbursement of expenses arising out of the occupancy.

A 3-day notice to pay rent or quit form should provide for the itemization of rent and other amounts due which are unpaid and delinquent. [See **first tuesday** Form 575]

Lump sum late charges

Under a nonresidential lease agreement entered into by a tenant, rent is typically due and payable on the first day of each month, called the *due date*. The lease contains a late charge provision stating the tenant agrees to pay a charge in the amount of $150 in the event the rent is not **received by** the landlord on or before the fifth day of each month, called a *grace period*. [See **first tuesday** Form 552 §3.9]

Under the lease, rent is *delinquent* the day after the grace period runs, the sixth day of the month. The delinquency triggers the landlord's right to demand the late charge or do nothing and waive it.

The lease also provides for the tenant to pay $25 for each rent check returned for insufficient funds (NSF). [See **first tuesday** Form 552 §3.10]

One month, the landlord receives the rent after the grace period has run. As he must, the landlord accepts the rent since the right to possession has not been terminated. The landlord then notifies the tenant in writing that he is imposing the agreed-to late charge, payable as agreed with the following month's rent. The following month the landlord receives the regularly scheduled rent within the grace period. However, the tenant does not also tender the late charge the landlord demanded on the prior month's delinquent payment.

Landlord's options for collection

On the tenant's failure to pay additional charges, the landlord's options to enforce payment, viable or not, include:

- returning the rent check to the tenant as insufficient payment for the amount due;
- serving the tenant with a 3-day notice to pay or quit;
- deducting the additional charge from the security deposit on written notice to the tenant; or
- filing an action against the tenant in small claims court to collect the late charge.

Returning the rent check to the tenant will result in one of two scenarios:

1. The tenant will submit another check which includes payment of the late charge (which payment will be delinquent and presumably incur another late charge).

   or

2. The tenant will retain the rent check as having been properly tendered and therefore paid, and do nothing more until he sends a check for the following month's rent.

A tenant who fails to pay rent or otherwise *materially breaches* the lease, may be served with the appropriate 3-day notice. The 3-day notice based on a material breach properly includes a demand for late charges and any other *amounts past due*. [Canal-Randolph Anaheim, Inc., *supra*]

If the tenant fails to cure the breach within three days following service of the notice and remains in possession, the landlord may file an unlawful detainer (UD) action to regain possession. [Calif. Code of Civil Procedure §1161]

However, a landlord will not succeed in a UD action when the landlord's refusal to accept the tenant's timely tender of a rent check is based solely on the tenant's refusal to pay late charges, which is a minor breach. [Canal-Randolph Anaheim, Inc., *supra*]

Thus, the landlord has two **viable options** for the collection of unpaid late charges from the tenant:

- accept the rent check and deduct the amount of the unpaid late charge from the security deposit and advise the tenant of the deduction; or
- accept the rent check and file an action in small claims court or municipal court for the unpaid late charge amounts.

The only financially practical action the landlord can take when the tenant refuses to pay a late charge is to accept the rent and deduct the late charge from the security deposit.

A UD action cannot be maintained if the sole existing breach of the lease is the failure to pay the late charges. A *material breach* is required to support a UD action, such as a delinquency in the scheduled rent and other scheduled periodic compensation for occupancy and use of the property. A late charge is properly sought when pursuing delinquent rent, but a late charge (or bounced check charge) is a *minor breach* and will not independently support a UD action. [**Baypoint Mortgage** v. **Crest Premium Real Estate Investments Retirement Trust** (1985) 168 CA3d 818]

Late charges

To be enforceable, late charges must be *reasonably related* to the actual costs of collecting the delinquent rent (the time and effort involved) and the delay in its receipt (loss of use, such as interest).

A lump sum (or interest rate) late charge becomes an unenforceable liquidated damage if the amount of the charge imposed is significantly greater than the actual out-of-pocket losses suffered by the landlord due to the tenant's late payment of rent, in which case the charge is called a penalty. [**Garrett** v. **Coast and Southern Federal Savings and Loan Association** (1973) 9 C3d 731]

Editor's note — Some may argue any lump sum late charge on residential property is void as a liquidated damage since losses due to a late payment in any real estate transaction, especially residential, are readily ascertainable.

A liquidated damages provision in a residential lease is void, unless the loss covered is impracticable or impossible to calculate (which it is not), or the amount agreed to is a reasonable estimate of the landlord's out-of-pocket expenses for the collection effort. [Calif. Civil Code §1671(c)(2)]

When setting the amount of a late charge for a residential tenant's failure to timely pay rent under a lease or rental agreement, consider charging an amount equivalent to the late charge allowed on a residential loan since it is a good indicator of *reasonableness*.

The late charge which can be charged for receipt of a delinquent payment on a loan secured by residential property is controlled by statute. Not so for rent.

For example, the lump sum late charge allowed on a loan secured by an owner-occupied, single-family residence cannot exceed 6% of the delinquent payment (principal and interest only). [CC §2954.4(a)]

Rent is the economic equivalent of interest. For purposes of late charges, rent payments should be treated no differently than interest payments.

Late charges as liquidated damages

A lump sum late charge set forth in a real estate lease is a *liquidated damages* provision. The charge is a one-time, predetermined fixed amount intended to reimburse the landlord for the delay in receipt of the rent money and his costs and effort spent to collect the delinquent rent. [CC §1951.5]

A late charge provision which calls for *interest to accrue* at a predetermined annual percentage rate on amounts earned and unpaid (delinquent rent) is not a liquidated damages provision and is fully enforceable. [Canal-Randolph Anaheim, Inc., *supra]*

However, some landlords wrongfully view late charges as a means for **coercing tenants to pay** the rent on time. Thus, they set the late charge at an amount which more than reimburses the landlord for his actual losses, a penalty assessment that is unenforceable.

A lump sum late charge provision in a **nonresidential lease** is valid unless the tenant can show the amount of the late charge is an unreasonable reimbursement for the delay in receipt of the rent. [CC §1671(b)]

A late charge is unenforceable if the charge is so great in comparison to actual losses that it *imposes a penalty* on the tenant for his late rental payment. [Garrett, *supra*]

An appropriate late charge in a lease for single-user residential or nonresidential property encumbered by a loan is the amount of the late charge imposed when a monthly payment on the loan is delinquent. The landlord is simply "passing through" the loss incurred by his late receipt of the tenant's rent payment.

However, in a residential lease agreement, a late charge provision setting a fixed amount is void unless the losses suffered by the landlord due to late payment are impracticable to calculate. [CC §1671(c)(2)]

Editor's note — Determining money losses suffered due to late payments in any real estate transaction, especially in a residential lease, is not impracticable to calculate since it is merely an accounting of known amounts incurred as expenses in the collection and lost use of the funds until received.

Imposing the late charge

A late charge is not automatically due and payable by the tenant when the landlord fails to receive the rent payment within the grace period.

The landlord must first make a written demand on the tenant for payment of the late charge and include the date when the charge is payable before the amount is delinquent and collection can be enforced.

Thus, a written billing demanding payment of the late charge with the next month's rent is delivered to the tenant to ensure the late charge is imposed. [See **first tuesday** Form 568]

The **late charge notice** advises the tenant the landlord is entitled to enforce collection of unpaid late charges by:

- deducting the unpaid delinquent amount from the tenant's security deposit; or
- filing a small claims or municipal court action for unpaid delinquent amounts.

Too late to collect

Within one year from the date rent became delinquent or some other *material breach* of a monetary provision in the lease or rental agreement occurred, the landlord must serve a 3-day notice on the tenant to be able to enforce collection of the amounts due in a UD action. [CCP §1161(2)]

As an alternative to seeking a recovery of money in a UD action, the landlord can file a separate action for money within four years of the breach, to collect unpaid late charges, returned check handling charges and any other amounts due under the lease. [CCP §337]

Ultimately, the landlord can deduct the late charges from the tenant's security deposit as payment of unpaid amounts due the landlord under the lease. [CC §§1950.5(b)(1); 1950.7(c)]

Editor's note — Within three weeks after vacating ***residential property***, a residential tenant is entitled to an accounting statement itemizing the prior deduction from the security deposit for the unpaid late charges, as well as any other deductible expenses incurred by the landlord. [CC §1950.5(f)]

Within two weeks after the landlord of ***nonresidential property*** receives possession from the tenant, the landlord must return the portion of the security deposit remaining after deductions for necessary cleaning, repair and other amounts due. [CC §1950.7(c)]

However, a nonresidential landlord is not required to set forth an itemized accounting of amounts deducted from a security deposit unless agreed to in the lease.

The UD court problem

While the enforcement of lump sum late charges for the recovery of collection efforts has not been the subject of reported cases, the court in *Canal-Randolph* Anaheim, Inc. ruled an interest-rate late charge on delinquent rent to cover the loss of use of the payment can be included as *amounts due* under a lease or rental agreement.

Canal-Randolph Anaheim, Inc. clarified that a landlord may include any sums due under the lease as amounts due in the 3-day notice.

Also, no statutes exist which forbid (or limit) the collection of a late charge in a lease or rental agreement. Cases do limit the charge to an amount reasonably calculated to cover the losses inflicted by late payment.

However, not all trial judges agree late charges are part of the *amount due* under a 3-day notice. Despite the holding of *Canal-Randolph Anaheim, Inc.*, some judges declare late charges are not *rent*, the delinquency of which triggers use of a 3-day notice to pay or quit. [CCP §1161(2)]

Thus, these judges hold a late charge or bad check charge cannot be included in the 3-day notice as part of the *amount due*. If included, the demand would bar an eviction before those judges.

Before a landlord or a property manager includes any late charge (or other amounts due besides technical rent) in a 3-day notice as part of the total amount due, it should first be determined if the judge presiding over UD actions in their jurisdiction will allow a demand for late charges.

Judges vary in their approach to late charges:

- some judges allow *masked late charges* cloaked as a forgiveness of 6% to 10% of the scheduled rent, if paid before the rent (including the masked late charge) is considered delinquent — within five to 10 days after it is due;
- some judges allow a late charge of up to 6% of the delinquent rent as a reasonable amount;
- some judges disallow late charges as an unenforceable penalty for being delinquent;
- some judges disallow late charges as a forfeiture of money (since the amount exceeds the costs of collection); and
- some judges just disallow late charges altogether as an exercise of their discretion.

Information on the treatment given by the local trial court judge can be obtained from an attorney or other landlords who have experience in front of the judge.

If the judge will not allow the late charge as part of the amount due from the tenant, the landlord should leave it out of the 3-day notice. Instead, either deduct the late charge from the security deposit (if any remains when refunded), or pursue collection in a separate action for money, both of which avoid the issue of demands placed in the 3-day notice. Do not risk getting an erroneous judicial determination that late charges or other amounts due were improperly included in the 3-day notice and therefore a denial of the eviction.

Editor's note — An obvious solution to the inconsistent rules applied to late charges is legislation to establish public policy by defining the nature of late charges and acceptable limits for recovery of the cost of collecting delinquent rent — guidance for all involved in the UD process.

Late charges for rent should be treated like late charges on mortgages. Both serve the same economic function — recovery of costs incurred due to the delay of receipt of funds and collection efforts. Also, the number of homeowners with mortgage payments is almost equal to the number of renters with rental payments in California. Both mortgage payments and rental payments are part of the cost of occupancy and entitled to equivalent legislative controls.

Chapter 26 Recovery of residential turnover costs

This chapter discusses how rent, not masked security deposits or other one-time fees, is a residential landlord's sole source for funds to pay for tenant turnover costs.

The security deposit plays no role

The landlord of an apartment complex is determined to reduce or offset the costs of tenant turnover by "shifting the costs" to the tenants.

An increasing number of his tenants are staying for shorter periods of time. On vacating, the units are re-renting quickly, keeping lost rent due to "turn-around" at a minimum.

However, each tenant turnover requires expenditures to:

- refurbish the unit to eliminate the cumulative effect of normal wear and tear, such as painting the walls, deep-cleaning the carpet and dry-cleaning the drapery;
- advertise the unit's availability to locate a tenant;
- pay for time and effort spent showing the unit and clearing prospective tenants; and
- pay the property manager's tenant-origination fee.

Since the rate of tenant turnovers is exceeding normal expectations, the landlord's *net operating income* (NOI) is being reduced by excessive refurbishing and reletting costs. [See **first tuesday** Form 352]

From the landlord's point of view, the NOI consists of amounts remaining from rental income generated by the property after deducting expenses incurred in operating the property — prior to deductions for interest paid on purchase and improvement loans and depreciation.

The landlord is concerned about the economics of the property since the *value* of the property for establishing its net worth (equity), maximum loan amount and sales price is based on the NOI. Also, *spendable income* slips due to increasing turnover costs.

To increase the property's NOI and net spendable income, the landlord chooses to add a *stay-or-pay* clause to his month-to-month rental agreements.

The stay-or-pay clause calls for the residential tenant to forego a return of his security deposit if he moves within six months after taking occupancy. [See Figure 1]

The landlord believes the stay-or-pay clause will dissuade month-to-month tenants from moving for at least six months.

If a tenant is unpersuaded and vacates the premises within the first six months, the stay-or-pay clause states the landlord can recover his "prematurely incurred" turnover costs from the tenant's security deposit.

Can the landlord enforce the stay-or-pay clause in his rental agreements based on sound economic policies?

No! The stay-or-pay clause is unenforceable. It is an illegal forfeiture of the security deposit.

If the tenant has not breached the lease or rental agreement and on expiration of proper notice returns the unit in the condition it was received, normal wear and tear excepted for the use allowed, the security deposit must be fully refunded no matter how long the unit remains vacant.

The security deposit **may not** be used to cover rent lost for the period of the vacancy or costs incurred to eliminate normal wear and tear and refurbish the unit for the next tenant. [Calif. Civil Code §1950.5(e)]

Thus, the landlord cannot use the stay-or-pay clause in tandem with the security deposit to cut a better deal for himself in the form of more revenue (rent) to cover his operating costs. Revenue for operating expenses must come from rents, not a one-time lump sum advance payment.

Classifying the receipt of tenant funds

Funds received from a tenant by a **residential landlord** fall into only four classifications of receipts:

- tenant screening fees;
- waterbed administration fees;
- rent; and
- security deposits.

The amount of the **tenant screening fee** may not exceed $30, or an amount annually adjusted from an original statutory amount of $30 in 1998 based on the Consumer Price Index (CPI).

Further, the amount of the tenant screening fee is limited to:

- the out-of-pocket cost for gathering the information; and
- the cost of the landlord's or property manager's time spent obtaining the information and processing an application to rent. [CC §1950.6(b)]

Rent is compensation, usually periodic, received as revenue by a landlord in exchange for the tenant's use, possession and enjoyment of the property. [**Telegraph Ave. Corporation** v. **Raentsch** (1928) 205 C 93]

Rents also include any late charges agreed to and demanded on the delinquent payment of periodic rent. [**Canal-Randolph Anaheim, Inc.** v. **Moore** (1978) 78 CA3d 477]

A charge for any purpose other than rent, a tenant screening fee or a waterbed administration fee is a refundable security deposit, regardless of the name or form given to the funds received. [**Granberry** v. **Islay Investments** (1984) 161 CA3d 382]

A **security deposit** is any advance payment designed to be used as security for the tenant's future performance of his obligations agreed to in a rental agreement or lease.

Figure 1 *(an unenforceable provision)*

A stay-or-pay minimum tenancy clause

If the tenancy is terminated during the six-month period following commencement of this agreement, tenant shall forfeit tenant's security deposit.

Security deposit deductions

When one month's rent is collected in advance from a residential tenant, the **security deposit is limited** to an amount equal to:

- two months' rent for an *unfurnished unit*; or
- three months' rent for a *furnished unit*. [CC §1950.5(c)]

A residential landlord may deduct from the security deposit those amounts reasonably necessary to:

- cure tenant defaults in the payment of rent;
- repair damages to the premises caused by the tenant;
- clean the premises except for normal wear and tear; and
- dispose of abandoned personal property. [CC §1950.5(b)]

Any amount of security deposit remaining after taking allowable deductions must be refunded to the residential tenant within three weeks after the tenant moves out. [CC §1950.5(f)]

A residential landlord's retention of any portion of a security deposit in violation of the deduction rules subjects the landlord to statutory penalties of up to twice the amount of the security deposit, in addition to actual damages. [CC §1950.5(l)]

Is it extra rent or a screening fee?

A landlord funds the care and maintenance expenses of property from rents, not from an initial lump sum amount paid in addition to rent.

Consider a residential landlord who requires new tenants to prepay one month's rent and make a refundable security deposit equal to one month's rent before entering into a lease or rental agreement.

In addition, the landlord charges a one-time, nonrefundable, new-tenant fee, membership fee or application expense reimbursement fee.

The purpose of the **nonrefundable fee** is to cover administrative expenses and services related to **processing** the tenant's application to rent the unit.

A tenant seeks to recover the one-time extra charge, claiming it is a nonrefundable security deposit since the lump sum charge covers expenses which must be recovered through amounts collected as rents and thus makes it a security deposit.

Can the tenant recover the one-time extra charge imposed by the landlord as a masked security deposit?

No, not as a security deposit! The one-time charge for administrative costs incurred by the landlord to process the tenant's rental application is not a security deposit. A security deposit is imposed and collected to secure the landlord against future tenant defaults under the lease or rental agreement by providing a source of recovery for any loss caused by the default. [Krause v. Trinity Management Service, Inc. (2000) 23 C4th 116; CC §§1950.5; 1950.6]

However, a "nonrefundable upfront fee" is controlled by the tenant screening fee statute which limits the amount of the application processing fee to $30. Thus, the difference is refundable as an excess charge which is neither rent nor a security deposit.

Unenforceable liquidated damages

Consider a residential landlord who includes a *liquidated damages* provision in the rental agreement in an effort to reduce or offset his tenant turnover costs. [See Figure 2]

In addition to the first month's rent, the landlord properly collects a security deposit from the tenant in an amount equal to one month's rent to cover any future breach of the rental agreement by the tenant.

Before six months runs, a tenant gives 30 days' notice to the landlord and vacates the unit.

Within 21 days of vacating, the landlord sends the tenant an itemized accounting of the security deposit, deducting one month's rent for the liquidated damages agreed to and owed due to the early (and proper) termination of the month-to-month rental agreement.

The tenant claims the security deposit must be refunded since a **liquidated damages** provision in a rental agreement or lease is unenforceable as a *forfeiture*.

Is the liquidated damages provision unenforceable?

Yes! A liquidated damages provision is unenforceable in residential rental agreements and leases. The amount of recoverable losses a residential landlord incurs when a tenant vacates a unit, such as the lost rent and the maintenance costs of labor and materials to cover excess wear and tear, is readily ascertainable. [CC §1671(d)]

A liquidated damages provision may only be enforced when conditions make it extremely difficult or impracticable to determine the amount of actual money losses. This is never the case in real estate rentals. [CC §1671(d)]

Further, liquidated damages do not represent a recovery of **actual money losses** incurred by the landlord, losses which without calling for a forfeiture could be deducted from the security deposit. The purpose of the landlord's liquidated damages provisions is not to recover money lost due to unpaid rent owed or excessive wear and tear.

Even if the landlord does not deduct the liquidated damages amount agreed to from the security deposit, he will not be able to recover the liquidated damages from the tenant in a civil action.

Covering tenant turnover costs

Recovery of a landlord's turnover costs must come from the periodic rents bargained for and received from his tenants — an expense of operations deducted from income.

Figure 2 *(an unenforceable provision)*

A liquidated damages minimum tenancy provision

Should the tenant choose to terminate this tenancy during the six-month period beginning on commencement of this tenancy, the tenant shall pay as *liquidated damages*, and not as a penalty or forfeiture, an amount equal to one month's rent in consideration for exercising the right to vacate prematurely.

The costs of refurbishing a unit to eliminate normal wear and tear so it can be re-rented in a "fresh" condition are known in advance. Further, the amount of the refurbishing costs must be amortized over the length of each tenant's probable occupancy period so the costs can be recovered as a component of the periodic rent charged to a tenant.

However, since the rental marketplace sets rent ceilings, a landlord is limited in the amount he can charge for rent and successfully compete for tenants.

Thus, a landlord's most logical cost recovery approach is to stretch out each tenant's term of occupancy to an optimal length of time which will reduce the frequency of tenant turnover and increase net spendable income.

The lease reduces costs

The landlord's best method for recovering turnover costs is to rent to creditworthy tenants on a lease with a term of more than one year, local rental market permitting. Rent may have to be adjusted.

A lease allows the landlord to amortize the anticipated costs of refurbishing the unit over the maximum term negotiable. Also, the lease of a unit reduces the frequency of vacancies and provides a schedule for turnover maintenance since tenants under a lease tend to remain in possession until the lease term expires.

Although the market limits the amount a landlord can charge for rent, different rental rates exist for leases and rental agreements in most local markets.

Month-to-month tenancies provide less time over which the landlord can amortize his turnover costs. Also, a landlord with month-to- month tenants must deal with the likelihood of frequent turnovers and the investment of time and money to constantly re-rent vacant units.

As compensation, a landlord is able to charge higher rents for month-to-month tenancies which reflects the cost-push of higher and more frequent turnover expenses than under a lease.

In contrast, a lease locks a tenant into a fixed period of occupancy, such as one year or more. Leases reduce the tenant turnover rate, and in turn, reduce operating costs and lost rent due to vacancies. Thus, the landlord amortizes his anticipated turnover costs over a greater period of time.

As a result, the lower rent usually received on leases is a reflection of lower overall refurbishing expenses, reduced annual vacancy rates, less management and usually less risk of lost rents.

Tiered rents for time in occupancy

A month-to-month rental agreement structured with tiered rents for future periods of occupancy provide for a slightly higher rent for months included in the first-tier period — such as the first six months of the periodic tenancy — than in the following months.

If the month-to-month tenant continues in occupancy after the first-tier period, the rental agreement calls for a lower rent during a second-tier period or for the remainder of the occupancy, both rates being consistent with the marketplace, of course.

Tiered rents which decrease after a period of time encourage tenants to stay longer since their rent will be lower.

Thus, the landlord's turnover costs are amortized and "reserved" through the higher periodic rent charged during the first tier.

If the month-to-month tenant does vacate on 30 days notice before the period of higher first-tier rent ends, less of the landlord's turnover costs prematurely incurred due to the early vacancy are left unamortized.

However, tiered rents will only avoid the security deposit limitations if:

- a security deposit of a customary amount is charged;
- the higher monthly rent is consistently charged over a long enough period so as not to be characterized as a disguised or delayed receipt of a security deposit, application processing (screening) fee, cleaning fee or forfeiture; and
- the tenancy is month-to-month.

It is not certain that tiered rents will never be construed as a disguise for a nonrefundable security deposit, but it has become far less likely. [Krause, *supra*]

The same amortization logic applies to the cost of tenant improvements (TIs) made by a nonresidential landlord. For example, if the TIs are recovered over the first four years of a lease as part of the rent amount, the rent thereafter (second tier) could be reduced to an amount which reflects the elimination of the TI charges in order to induce the tenant to stay for a greater period of time.

Chapter 27 — Security deposits and pre-termination inspections

This chapter discusses the different rules for residential and nonresidential landlords who receive and refund security deposits, and the residential tenant's right to a pre-termination inspection.

Requirements for residential and nonresidential landlords

An investor, primarily in nonresidential income-producing properties, is acquiring his first residential rental property.

The residential rental property is a large apartment complex consisting of furnished and unfurnished units.

The investor retains a property manager with experience in managing apartment buildings of comparable size and quality in the local rental market.

Initially, the property manager inspects the units and, with the investor, reviews the impact of the local residential rental market on rents and security deposits.

As a result, rents and security deposits to be charged are established based on the size of the units, the maximum number of occupants for the various sizes of units, amenities each unit offers, the unit's location within the complex and whether or not the units are furnished.

The investor is aware he must rent to families with children whose credit and background qualify them as tenants. However, the investor is concerned about the excessive wear and tear children might cause to the units. Excessive wear and tear brought on by a tenant and remaining unrepaired when the tenant vacates is a breach of the lease, called a *default*. As a result, the landlord will incur additional cleanup expenses.

If a unit will be occupied by a family with children whose background check indicates they will likely place an excessive burden on the unit, the broker can recommend the rent be adjusted upward to cover the additional wear and tear brought about by the increased number of occupants.

However, the investor would like to impose a larger security deposit equal to one-half month's rent for each child who will occupy a unit since the increased deposit would either discourage large families from renting or provide funds to restore the unit for re-renting when they vacate.

The property manager informs the investor security deposits charged to tenants of residential units are controlled by statute calling for *nondiscriminatory, equal treatment*, unlike security deposits negotiated by landlords and tenants of nonresidential property.

Thus, the investor is warned he cannot require higher security deposits for tenants with children than for tenants without children. Any increase in a security deposit for families is a prohibited discriminatory practice. [Calif. Government Code §12955(a); 24 Code of Federal Regulations §100.65]

Also, other limitations are placed on the upfront charges for rent and security deposits. In addition to the collection of one month's advance rent, the maximum amount which a residential tenant may be required to pay as a security deposit to cover defaults during the period of occupancy is limited to:

- two months' rent for unfurnished units; and
- three months' rent for furnished units. [Calif. Civil Code §1950.5(c)]

Thus, if supported by the local rental market, the investor may require of all tenants, an advance payment of the first month's rent and either:

- the last month's rent and a security deposit equal to one month's rent; or
- a security deposit equal to two months' rent.

The property manager informs the investor a security deposit equal to one month's rent, together with one month's advance rent, is all the market will currently bear for his units. If he demands more, the units will not readily rent.

Security against nonperformance

Both nonresidential and residential landlords traditionally require tenants to deposit money in addition to rent. [See **first tuesday** Forms 550 §1.1 and 552 §1.2]

The additional deposit is **security** for any default in the tenant's future performance of obligations the tenant agrees to in the lease or rental agreement. Tenant obligations include paying rent, reimbursing the landlord for expenses incurred due to the tenant's conduct, maintaining the premises during the occupancy and leaving the premises in the same level of cleanliness it was in when leased to the tenant, less ordinary wear and tear.

However, for residential rentals, all money paid to the landlord **in addition** to the first month's rent, screening fee and waterbed administrative fee is considered a security deposit. Security deposits include any funds received for the purpose of covering defaults by the tenant under the lease/rental agreement, no matter the name given to the funds by the landlord, such as a nonrefundable deposit or last month's rent. [CC §§1940.50; 1950.5(b), (c); 1950.6]

Thus, any funds legally recharacterized as a security deposit are refundable when the tenant vacates, less deductions for unpaid rent or costs incurred by the landlord, such as for the repair of damages caused by the tenant or for the cleaning of the premises. [CC §§1950.5(b); 1950.7(c)]

The amount a nonresidential landlord will ask for as a security deposit should be based on the risk of loss the tenant's business success poses for the landlord.

For nonresidential tenancies, a small services firm may pay an amount equal to one month's rent as a security deposit, while a photography studio which uses chemicals in its film processing may be asked to pay an amount equal to two month's rent.

Editor's note — A photography studio tenant or other users of chemicals may also be required to provide insurance coverage.

In a market downturn, aggressively competitive landlords are less likely to require a security deposit in exchange for maintaining current rental income (occupancy), and thus expose themselves to an increased risk of loss should the tenant default.

Like all other terms in a nonresidential lease, the security deposit is negotiated between the nonresidential landlord and the tenant prior to entering into the lease.

Unlike nonresidential tenants, residential tenants, as a matter of public policy, are perceived as lacking bargaining power when they negotiate a lease or rental agreement. Thus, limits are imposed by law on the amount of security deposit a residential landlord may require.

Last month's rent

When unfurnished residential vacancies are low, landlords often require the maximum permissible amount of advance payment, which includes the first and last month's rent, plus a security deposit equal to one month's rent to eliminate the less solvent tenants.

Editor's note — Legally, this is recharacterized as one month's advance rent and a security deposit equal to two month's rent. [CC §1950.5(c)]

Nonresidential landlords also generally require an advance payment of both the first and last month's rent on a lease.

However, the local rental **market conditions** may prevent a residential or nonresidential landlord from requiring:

- a security deposit in addition to first and last months' rent; or
- a security deposit equal to two months' rent and advance payment of one month's rent.

Now consider a tenant who pays the first month's rent and a security deposit equal to one month's rent on entering into his lease.

When the last month's rent becomes due the tenant does not pay, knowing the defaulted payment of rent will be deducted from his security deposit, a permissible use of the security deposit by the landlord on the tenant's default in the last month's rent payment.

On expiration of the lease, the tenant vacates the unit. Due to excess wear and tear on the unit by the tenant, repairs and replacements are required before the unit can be re-rented.

However, after deducting the unpaid last month's rent from the security deposit, no security deposit remains to reimburse the landlord for the cost of the repairs.

Since the landlord did not require an advance payment of both the first and the last month's rent, as well as a security deposit (or a security deposit equal to two months' rent), his recovery of the repair costs is limited to a demand on the tenant, and if unpaid, a small claims court action to enforce collection.

A similar result may occur if the landlord requires advance payment of the first and last month's rent, but no security deposit.

Editor's note — The landlord could promptly serve a 3-day notice to pay or vacate on expiration of the grace period before delinquency, and on expiration of the 3-day notice without payment or vacating, file an unlawful detainer (UD) action.

Residential deposits

A residential landlord must require the same security deposit for all units, such as an amount equal to one month's rent, or base the amount of security deposit on each tenant's creditworthiness.

Editor's note — If a landlord sets the security deposit amount based on a tenant's creditworthiness — the greater or lesser risk of a loss due to a prospective tenant's failure to perform on lease provisions — he must establish clear and precise standards for his different levels of creditworthiness and apply each level's credit standards equally to all prospective tenants who fall into that level of credit. [24 CFR §100.60(b)(4)]

A residential landlord has limited authority to require an additional **pet deposit** if the tenant is permitted to keep one or more pets in the unit.

However, the total security deposit received from a tenant **with a pet** may not exceed the maximum security deposit allowed, such as an amount equal to two months' rent for an unfurnished unit or three months' rent for a furnished unit.

However, these security deposit limitations may be exceeded when a tenant maintains a **waterbed on the premises**. The residential landlord may then require:

- an amount equal to one-half month's rent, in addition to the maximum security deposit; and
- a reasonable fee to cover administrative costs of processing the waterbed arrangements. [CC §1940.5(g)]

Also, if the term of a residential lease is six months or more, the landlord and tenant may agree to the tenant's advance payment of six months' rent or more, instead of one month's rent. [CC §1950.5(c)]

Thus, advance payment of only two to five month's rent is prohibited.

Should the landlord and tenant agree to an advance payment of six months' rent on the lease of an unfurnished unit, the landlord may also require the maximum security deposit of two months' rent.

Any money handed to a residential landlord by a tenant on entering into a lease or rental agreement must be characterized as one of the following:

- a tenant screening fee for processing an application;
- a waterbed administrative fee;
- rent; or
- a security deposit. [CC §§1940.5(g); 1950.5(b); 1950.6(b)]

Holding security deposits

Funds held by residential and nonresidential landlords, which are intended to cover defaults in the tenant's performance of his obligations on the lease or rental agreement, are called security deposits. The funds belong to the tenant who deposited them. [CC §§1950.5(d); 1950.7(b)]

However, a landlord may **commingle** security deposits with other funds in a general business account. No trust relationship is established when a landlord holds a tenant's security deposit. [**Korens** v. **R.W. Zukin Corporation** (1989) 212 CA3d 1054]

Since no trust relationship exits, the landlord's receipt of a security deposit imposes no obligation on him to pay **interest** on the security deposit for the period held.

However, some local rent control ordinances require residential landlords to pay interest to tenants on their security deposits (and the legislature has been actively thinking about extending this to all residential landlords).

For example, the city of San Francisco requires residential landlords to pay simple interest to tenants on security deposits held by the landlord for one year or more as long as the rent is not subsidized by any government agency. [San Francisco Administrative Code §49.2]

Joint pre-termination inspection

A residential landlord must notify a tenant in writing of the tenant's **right to request** a joint inspection of his unit within two weeks prior to the date the tenancy terminates due to:

- expiration of the lease term; or
- a notice to vacate initiated by either the landlord or the tenant. [CC §1950.5(f)(1); see Form 567-1 accompanying this chapter]

The purpose for the joint pre-termination inspection, legally called an *initial inspection*, is to require the landlord to advise the tenant of the repairs or conditions he needs to correct to avoid deductions from the security deposit.

If a residential tenant requests the pre-termination inspection, the landlord or his agent must complete the inspection no earlier than two weeks before the tenant is to vacate the unit.

Ideally, the notice advising the tenant of his right to a joint inspection should be given to the tenant at least 30 days prior to the end of the lease term or, in the case of a rental agreement, immediately upon receiving or serving a notice to vacate. A period of 30 days will allow the tenant time to request the inspection and provide two full weeks in which to participate in the inspection and remedy any repairs or cleaning the landlord observes during the inspection which might constitute a deduction from the security deposit.

On the landlord's receipt of the tenant's request for an inspection, the landlord must serve a 48-hour written notice of entry on the tenant stating the date and time of the pre-termination inspection. If the date and time cannot be mutually agreed to, they are to be set by the landlord. [CC §1950.5(f)(1); see **first tuesday** Form 567-2]

However, if an acceptable time for the inspection is within 48 hours, a written waiver of the notice of entry must be signed by both the landlord and tenant. [CC §1950.5(f)(1); see **first tuesday** Form 567-2]

If the waiver is signed, the landlord may proceed with the inspection, whether or not the tenant is present at the premises, unless the tenant has previously withdrawn his request for the inspection.

On completion of the pre-termination inspection, the landlord must give the tenant an itemized statement of deficiencies specifying any repairs or cleaning necessary to be undertaken by the tenant to avoid deductions from his security deposit. The itemized statement of deficiencies must contain the contents of subdivisions (b) and (d) of Civil Code §1950.5. [See Form 567-3 accompanying this chapter]

The pre-termination inspection statement must be served by either:

- giving the statement directly to the tenant if he is present at the inspection; or
- leaving the statement inside the premises if the tenant is not present. [CC §1950.5(f)(2)]

The purpose for the inspection and statement of deficiencies in repairs or cleanliness is to give the tenant time in which to attempt to remedy the identified repairs before vacating the premises.

NOTICE OF RIGHT TO REQUEST A JOINT PRE-TERMINATION INSPECTION

DATE:_____________, 20______, at ____, California

To Tenant:

NOTICE: Residential tenants may request a joint pre-termination inspection of the premises they occupy. At the inspection they will receive a statement of deficiencies itemizing the repairs and cleaning necessary to be remedied or eliminated by the tenant to avoid a deduction of their costs from the security deposit. [Civil Code §1950.5(f)]

Items left blank or unchecked are not applicable.

FACTS:

You are a Tenant under a rental agreement or lease

dated __________________, at ____, California,

entered into by ____, Tenant,

and____, Landlord,

regarding real estate referred to as: ____

which tenancy terminates or expires _____________, 20______.

NOTICE:

1. You are hereby advised of your right to request and be present at a pre-termination inspection of the premises you occupy, and at the time of the inspection, be given the Landlord's itemized statement of deficiencies specifying repairs and cleaning which will be the basis for deduction from your security deposit.

1.1 The purpose for the inspection and the statement of deficiencies is to give you the opportunity to remedy or eliminate the specified deficiencies before vacating to avoid a deduction of their cost from your security deposit.

1.2 The inspection, if requested by you, may be scheduled no earlier than two weeks before the termination/expiration of your tenancy, and is separate from the Landlord's final inspection after you vacate.

1.3 If you do not request a pre-termination inspection, no inspection will be made prior to the final inspection after you vacate.

2. You may request an inspection at any time after you are given this notice by preparing the form attached to this notice and giving it to the Landlord or his agent.

2.1 On the Landlord's receipt of your request, the Landlord will attempt to set a mutually agreeable date and time for the inspection.

2.2 On the Landlord's receipt of your request, you will be given a written 48-hour notice of entry advising you of the date and time scheduled by the Landlord for the inspection.

3. On completion of the scheduled inspection, whether or not you are present, the Landlord or his agent will hand you or leave on the premises a copy of an itemized statement of deficiencies specifying repairs and cleaning which will be the basis for deductions from your security deposit, unless you remedy or eliminate them prior to your vacating on or before your tenancy terminates or expires.

3.1 Once you have requested an inspection you may withdraw the request at any time prior to the inspection.

Date:_____________, 20______

Landlord/Agent:____

Signature: ____

Address: ____

____

Phone:____

Fax:____

E-mail:____

REQUEST FOR JOINT PRE-TERMINATION INSPECTION

DATE:_____________, 20______, at ____, California

To Landlord:

I, the Tenant, hereby request an inspection at the earliest possible date and time during the two-week period prior to the termination or expiration of my tenancy.

The dates I prefer for an inspection during normal business hours include: ______________________________________

I understand you will give me a 48-hour notice prior to the inspection.

Address of the premises: ____

Tenant's name: ____

Signature:____

Daytime telephone number:____________________

Alternatively, the tenant may choose not to request a pre-termination inspection, in which case the landlord or his agent will not have to conduct an inspection or prepare and give the tenant a statement of deficiencies.

However, the notice of the tenant's right to request a pre-termination inspection **must** be given to the tenant.

If the tenant chooses to withdraw after requesting an inspection, the landlord should send a memo to the tenant confirming the tenant's decision to withdraw. [See **first tuesday** Form 525]

Editor's note — The completion of a pre-termination inspection by the landlord does not bar the landlord from deducting from the security deposit for the costs of:

- *any damages noted in the joint pre-termination inspection statement which are not cured;*
- *any damages which occurred between the pre-termination inspection and termination of the tenancy; or*
- *any damages not identified during the pre-termination inspection due to the tenant's possessions being in the way. [CC §1950.5(f)]*

Regardless of whether or not the tenant requests a pre-termination inspection, the final inspection after the tenant vacates and the itemized statement for the refund of the security deposit less any deductions must still be completed and mailed within three weeks after the tenant vacates the residential unit. [CC §1950.5(g)]

Residential refund requirements

After a residential tenant vacates, the residential landlord must:

- refund the security deposit, less reasonable deductions; and
- provide the tenant with an itemized statement for any deductions from the security deposit, including documentation to support the deductions. [CC §1950.5(g); see Form 585 accompanying this chapter]

STATEMENT OF DEFICIENCIES
ON JOINT PRE-TERMINATION INSPECTION

DATE:_____________, 20______, at ____, California

To Tenant: ____

Items left blank or unchecked are not applicable.

FACTS:

1. On this date, a pre-termination inspection was conducted by the Landlord on the premises and appurtenances which are the subject of a rental agreement or lease

Dated __________________, at ____, California,

entered into by ____, Tenant(s),

and____, Landlord,

regarding real estate referred to as: ____

____

1.1 ☐ The Tenant was present and given a copy of this statement prepared and signed by the Landlord or his agent.

1.2 ☐ The Tenant was not present and a copy of this statement prepared and signed by the Landlord or his agent was left inside the premises.

2. The tenancy under the rental agreement or lease terminates or expires on _____________, 20______ by which date you are to vacate the premises.

3. NOTICE TO TENANT:

3.1 You have until the date for termination or expiration of your tenancy to remedy or eliminate the repairs and cleaning specified in this statement of deficiencies to avoid the deduction from your security deposit of the cost to repair and clean the identified deficiencies.

3.2 Unobservable conditions or conditions which occur after the pre-termination inspection requiring repair and cleaning will be deducted from your security deposit after the final inspection by the landlord or his agent.

STATEMENT OF DEFICIENCIES:

4. The following itemized list of identified deficiencies in repairs and cleaning will be the basis for deductions from your security deposit, unless remedied or eliminated by you prior to vacating and later confirmed by the Landlord or his agent during a final inspection.

4.1 Damage to the premises and appurtenances caused by the Tenant or their guests, other than ordinary wear and tear, which needs to be repaired are listed as follows: ____________________________________

____

____

____

____

____

____

4.2 Cleaning which needs to be performed to bring the premises up to the level of cleanliness which existed on commencement of the tenancy is listed as follows: ____

____

____

____

____

____

____

5. The following recitals are excerpts from Civil Code §1950.5 regarding security deposits:

5.1 1950.5(b) As used in this section, "security" means any payment, fee, deposit or charge, including, but not limited to, any payment, fee, deposit, or charge, except as provided in Section 1950.6, that is imposed at the beginning of the tenancy to be used to reimburse the landlord for costs associated with processing a new tenant or that is imposed as an advance payment of rent, used or to be used for any purpose, including, but not limited to, any of the following:

(1) The compensation of a Landlord for a Tenant's default in the payment of rent.

(2) The repair of damages of the premises, exclusive of ordinary wear and tear, caused by the Tenant or by a guest or licensee of the tenant.

(3) The cleaning of the premises upon termination of the tenancy necessary to return the unit to the same level of cleanliness it was in at the inception of the tenancy. The amendments to this paragraph enacted by the act adding this sentence shall apply only to tenancies for which the Tenant's right to occupy begins after January 1, 2003.

(4) To remedy future defaults by the Tenant in any obligation under the rental agreement to restore, replace, or return personal property or appurtenances, exclusive of ordinary wear and tear, if the security deposit is authorized to be applied thereto by the rental agreement.

5.2 1950.5(d) Any security shall be held by the Landlord for the Tenant who is party to the lease or agreement. The claim of a Tenant to the security shall be prior to the claim of any creditor of the Landlord.

Date:_____________, 20______

Landlord/Agent: ____

Signature: ____

Address: ____

____

Phone: ____

Fax:____

The landlord must deliver the itemized statement of deductions and any security deposit remaining **no later than 21 days** after the tenant vacates the premises, but not earlier than:

- the time a notice of the termination of tenancy is provided by either the landlord or the tenant; or
- 60 calendar days prior to the expiration of a lease. [CC §1950.5(g)(1)]

The itemized security deposit refund statement is to include **copies of receipts, invoices and/or bills** showing the charges incurred by the landlord which are deducted from the security deposit. Specifically, the itemized statement must include:

- a description of the work performed and the time spent by **employees** of the landlord in performing the work and the hourly rate charged [CC §1950.5(g)(2)(A)];
- copies of bills, invoices and receipts for work performed for the landlord by persons other than his employees. If these bills, invoices or receipts do not include the amount of charges incurred by the landlord, the itemized statement to the tenant must then include the name, address and telephone number of the person or company who performed the work. [CC §1950.5(g)(2)(B)]

If within 21 days after the tenant vacates the repairs are not completed or bills, invoices or receipts for repairs performed by others have not been received by the landlord, the landlord may deduct a **good faith estimated amount** of the cost of repairs from the tenant's security deposit. The estimate must appear on

the itemized security deposit refund statement, together with the name, address and telephone number of the other person or company providing repair work, materials or supplies.

Within 14 days after the **completion of repairs** or the receipt of bills, invoices or receipts for the repairs and materials, the landlord must complete the delivery to the tenant of the receipts and invoices which were to have been included with the security deposit refund statement.

The landlord is **excused** from providing copies of receipts, bills and/or invoices for repair work or cleaning to the tenant with the security deposit refund statement if:

- the total deduction from the security deposit to cover the cost of repairs and cleaning does not exceed $125; or
- the tenant signs a *waiver of his right* to receive bills, invoices or receipts, which waiver is entered into on or after notice to terminate his tenancy is provided under a rental agreement (or breached lease) or within 60 days of expiration of a lease. [CC §1950.5(g)(4)]

However, while excused from including documentation for deductions with the refund statement, a tenant may later request copies of receipts, bills or invoices for repair work or cleaning within 14 days after receipt of the itemized security deposit refund statement, and the landlord is to provide copies of the documents within 14 days after receipt of the tenant's request. [CC §1950.5(g)(5)]

The itemized statement must be **delivered** to the tenant by first-class mail or in person. When mailed, the itemized security deposit refund statement and attachments is to be sent to the tenant at the address provided by the tenant. If no address is provided, the documents are to be mailed to the tenant's vacated unit.

If the last month's rent on a lease is prepaid, it is considered a security deposit since it has not yet been earned. Prepaid rent must be accounted for as a security deposit if the tenant vacates before expiration of the lease (and the arrival of the month for which rent has been prepaid).

Reasonable deductions from a residential tenant's security deposit include:

- delinquent rent;
- costs to clean the premises after the tenant vacates, if the tenant agreed to and failed to leave the unit in the same level of cleanliness as when he took occupancy;
- costs of repairs for damages caused by the tenant, excluding ordinary wear and tear; and
- costs to replace or restore furnishings provided by the landlord if agreed to in the lease. [CC §1950.5(b)]

Unpaid late charges incurred on a proper demand may be deducted from the security deposit since they are a **form of rent** in that they are **amounts due** the landlord under the lease agreement.

The landlord may not deduct from a tenant's security deposit the costs he incurs to repair defects in the premises which existed prior to the tenant's occupancy. [CC §1950.5(e)]

Tenants seeking to recover security deposits retained by landlords may make unfounded claims that the excessive wear and tear existed when they took possession of the property. To best avoid claims of pre-existing defects, a joint inspection of the unit (landlord and tenant) and written documentation of any defects should be completed **before possession** is given to the tenant. [See **first tuesday** Form 560]

SECURITY DEPOSIT DISPOSITION
ON VACATING RESIDENTIAL PREMISES

DATE:_____________, 20______, at ____,California

To Tenant: ____

NOTICE: This itemized statement of the security deposit's disposition, including documentation of charges deducted, must be given to the tenants by the landlord within 21 days after a tenant vacates residential property. [California Civil Code §1950.5(f)]

Use of this form in a timely and proper fashion avoids landlord liability for 2% monthly penalty on any portion of the security deposit wrongfully retained.

Items left blank or unchecked are not applicable.

FACTS:

This is notice to the tenant of any Landlord deductions from the security deposit under the following agreement:

☐ Residential lease agreement
☐ Month-to-month residential rental agreement
☐ Occupancy agreement
☐ Other:

Dated __________________, entered into by ____,Landlord,
and ____, Tenant,
regarding residential premises referred to as: ____
____

DISPOSITION OF DEPOSIT:

1. Under the above referenced agreement,
Tenant handed Landlord a security deposit in the amount of . . . . $_______________

2. The following deductions have been made by Landlord from the security deposit:

2.1 Repair of damages — Cost
a. ____ $_______________
b. ____ $_______________

2.2 Necessary cleaning of the premises — Cost
a. ____ $_______________
b. ____ $_______________

2.3 Delinquent or holdover rent — Amount
a. From:____________________To:______________________ $_______________

2.4 Replacement/repair of lost or damaged furnishings — Cost
a. ____ $_______________

2.5 TOTAL deductions from security deposit. . . . . $_______________

3. ☐ **BALANCE DUE TENANT**:

3.1 Balance of security deposit remaining after deductions . . . . $_______________

3.2 Interest on the security deposit from ________________ to ________________
at ______% per annum . . . . $_______________

3.3 Balance due Tenant herewith refunded is the amount of. . . . . $_______________
by Landlord/Agent's check #_____________.

4. ☐ **BALANCE DUE LANDLORD:**

4.1 Balance remaining due Landlord for costs in excess of the security deposit . . . . $_______________

4.2 Less interest on the security deposit from ________________ to ________________
at _____% per annum . . . . $_______________

4.3 Tenant to hand or mail Landlord/Agent the balance due of . . . . $_______________

This statement is true and correct:

Date:_____________, 20______

Landlord/Agent: ____

Signature:____

Address:____

____

Phone:_______________________ Fax:________________________

By: ____

Itemized security deposit statements

When a residential tenant vacates, the landlord must itemize the deductions from the tenant's security deposit on a security deposit disposition. [CC §1950.5(g); See Form 585]

If a landlord is required by local rent control ordinances (or state law) to pay interest on security deposits, the landlord may also use the itemized statement to account for interest accrued on the security deposit. [See Form 585 §3.2]

A residential landlord who, in bad faith, fails to comply with security deposit refund requirements may be subjected to statutory penalties of up to twice the amount of the security deposit. [CC §1950.5(l)]

A residential or nonresidential landlord also delivers an itemized statement to tenants on the **sale of the property**, indicating the amount of the security deposits, any deductions and the name, address and telephone number of the buyer. [CC §§1950.5(h); 1950.7(d); see **first tuesday** Form 586]

Nonresidential refund requirements

A nonresidential lease does not need to set forth:

- the circumstance under which a tenant's security deposit will be refunded; and
- a time period within which a landlord will refund a tenant's security deposit.

Other than its receipt, a nonresidential lease does not even need to contain a provision addressing when the security deposit will be returned. [See **first tuesday** Form 552]

However, if **unpaid rent** is deducted from a security deposit after a nonresidential tenant vacates, the landlord is required to refund the security deposit within two weeks from the date he takes possession of the property.

Also, if a nonresidential landlord deducts amounts from a security deposit to cover the costs of cleaning or making repairs to the premises, any remaining portion must be refunded no more than 30 days from the date the landlord receives possession. [CC §1950.7(c)]

If a refund period is not agreed to and the nonresidential landlord does not take any deductions from the security deposit, the landlord must refund the security deposit within a reasonable time period.

Thirty days from the date the nonresidential landlord receives possession is a reasonable refund period since the landlord is allotted 30 days to determine whether repairs are needed. After 30 days, no good reason exists to continue to hold the deposit.

Unlike the residential landlord, the nonresidential landlord is not required to provide tenants with an itemized statement of deductions when the security deposit is refunded.

However, a prudent nonresidential landlord provides tenants with an itemized statement when they vacate, unless a full refund is made.

An accounting avoids the inevitable demand for documentation which arises when a tenant does not receive a full refund of his security deposit.

A nonresidential landlord who, in bad faith, fails to comply with the refund requirements is liable to the tenant for up to $200 in statutory damages. [CC §1950.7(f)]

Chapter 28 Accepting partial rent

This chapter distinguishes the differing rights held by residential and nonresidential landlords to file or continue an unlawful detainer (UD) action on receipt of partial rent.

Rights of residential and nonresidential landlords

A **nonresidential tenant**, also called a *commercial tenant*, experiences cash flow difficulties due to a business downturn. As a result, the tenant becomes delinquent in the payment of rent.

Discussions between the landlord and tenant follow. Eventually, to enforce collection of the rent, the landlord serves the tenant with a **3-day notice** to pay rent or quit the premises. [See **first tuesday** Form 575]

Prior to the filing of an unlawful detainer (UD) action, the tenant *offers* to hand the landlord a partial payment of the delinquent rent. However, the tenant wants to pay the balance of the rent by a specified date if the landlord will agree in writing to defer any filing of a UD action, called a **partial payment agreement**. [See Form 558 accompanying this chapter]

The partial payment agreement sets forth the amount of **deferred rent** remaining unpaid, the date for its payment and the consequences of nonpayment — eviction by a UD action without further notice.

Thus, if the deferred rent is not paid as rescheduled, the nonresidential landlord has the agreed-to **right to file** a UD action to evict the tenant without repeating the 3-day notice requirement for filing a UD action.

Here, the partial payment agreement has temporarily delayed the landlord from moving forward with the eviction process commenced by the service of the 3-day notice on the tenant.

Under the partial payment agreement, the nonresidential landlord has retained his right to proceed on the 3-day notice to evict by filing a UD action should the deferred payment for the balance of the delinquency not be received as rescheduled.

The tenant fails to pay the deferred remainder of the delinquent rent on the date scheduled for payment.

Without further notice to the tenant, the landlord files a UD action.

The nonresidential tenant now seeks to prevent the landlord from proceeding with the UD action claiming the landlord's acceptance of the partial rent payment invalidates the 3-day notice since the notice now states an amount of rent which is no longer due.

Can the nonresidential landlord accept a payment of partial rent after serving a 3-day notice and later file a UD action against the tenant without serving another 3-day notice?

Yes! A **nonresidential landlord** can accept a partial payment of rent after serving a 3-day notice before filing a UD action. Without further notice to the tenant, the nonresidential landlord can commence a UD action and evict the tenant. [Calif. Code of Civil Procedure §1161.1(b)]

Further, on accepting a partial payment of delinquent rent, a nonresidential landlord does not need to even agree to a due date for the remainder of rent. He also does not need to enter into any agreement regarding his acceptance of the partial payment if the tenant has previously been given a reservation of rights by the landlord, called a *nonwaiver provision* (which appears as a provision in nonresidential leases). [See **first tuesday** Form 552 §22]

However, the nonresidential landlord who memorializes his acceptance of the partial rent payment and the due date for payment of the remainder due eliminates conflicting claims by the tenant in a UD action about the tenant's expectations based on the landlord's acceptance of partial payment of rent.

Residential property distinguished

Now consider the same situation involving residential property instead of nonresidential property.

As for serving a 3-day notice and later accepting any amount of rent, a distinction exists between residential and nonresidential tenancies.

A **residential landlord** who accepts any amount of rent from a tenant after serving a 3-day notice waives his right to file a UD action based on the 3-day notice. A residential landlord must re-notice the tenant for the amount now remaining unpaid. [**EDC Associates, Ltd.** v. **Gutierrez** (1984) 153 CA3d 167]

Residential vs. nonresidential landlords

Acceptance of a partial payment on delinquent rent is within the discretion of the landlord.

A landlord may be willing to accept partial payments when:

- the partial payment is at least equal to the rent accrued at the time the tenant offers the payment;
- the tenant is creditworthy;
- the tenant has an adequate payment history; and
- the tenant is one the landlord wants to retain.

Both residential and nonresidential landlords may accept a partial payment of delinquent rent and at any time thereafter serve a 3-day notice demanding payment of the balance due or quit. However, a landlord could agree in a partial payment agreement not to serve a 3-day notice on receipt of the partial payment of rent conditioned on the payment of the balance at a later date. [See Form 558; see Form 559 accompanying this chapter]

The expiration of the 3-day notice to pay rent or quit without compliance establishes the tenant's unlawful detainer of the premises, which is the requisite for maintaining a UD action that will result in an eviction order. [CCP §1161]

Residential rent paid after notice

If a **residential landlord** files a UD action and later accepts a partial payment of rent, the UD action cannot be maintained. The reason lies in that a difference now exists between the rent demanded in the notice to pay to establish an unlawful detainer and the amount remaining delinquent at the UD hearing. In residential UD actions the amounts must be the same. The contrary rule applies to nonresidential tenancies.

PARTIAL PAYMENT AGREEMENT

Nonresidential

DATE:_____________, 20______, at ____, California

Items left blank or unchecked are not applicable.

FACTS:

This partial payment agreement pertains to the collection of past due rent under a nonresidential lease or rental agreement dated __________________, at ____, California, regarding leased premises referred to as: ____

____

AGREEMENT:

1. Tenant has not paid delinquent rent for the period of ____.

2. Landlord hereby accepts partial payment on delinquent rent in the amount of . . . . $_______________

3. The balance of the delinquent rent owed is . . . . $_______________

3.1 Plus late charge for delinquency of . . . . $_______________

3.2 Plus a deferred rent processing charge of . . . . $_______________

3.3 **Total deferred rent** due, including additional charges, is the sum of . . . . $_______________

4. Tenant to pay the total deferred rent on or before _____________, 20______.

4.1 Rent to be paid by ☐ cash, ☐ check, or ☐ cashier's check made payable to Landlord.

4.2 Rent may be tendered by ☐ mail, or ☐ personal delivery to:

____ (Name)

____ (Address)

____ (Phone)

a. Personal delivery of rent will be accepted during the hours of ______am to ______pm on the following days:

4.3 Rent may also be paid by deposit into account number ____

at: ____ (Financial Institution)

____ (Address)

____

4.4 No grace period for payment of the deferred rent is granted to Tenant.

4.5 Delinquent payment of the deferred rent incurs a late charge of $_______________

5. If deferred rent is paid when due, any outstanding three-day notice to pay rent or quit is no longer valid.

6. If the deferred rent is not paid when due, Landlord reserves the right to:
(Check one box only)

6.1 ☐ Serve Tenant with a three-day notice to pay the remaining balance of the rent due or quit the premises. *(Check if a three-day notice has not been served)*

6.2 ☐ Commence, without further notice, an unlawful detainer action to evict Tenant from the premises. *(Check if a three-day notice has been served)*

6.3 ☐ Continue with the unlawful detainer action on file to evict Tenant from the premises. *(Check if unlawful detainer action has been filed)*

7. ____

____

____

I agree to the terms stated above.	**I agree to the terms stated above.**
Date:_____________, 20______	Date:_____________, 20______
Landlord: ________________________________	Tenant:________________________________
Agent: ________________________________	Tenant:________________________________
Signature: ________________________________	Signature: ________________________________
Phone:________________________________	Signature: ________________________________
Fax: ________________________________	Phone:__________________Fax: _________________

Deferring the first month's rent

Consider a landlord who locates a creditworthy tenant for his residential property.

In addition to the advance payment of the first month's rent, the landlord requires a security deposit equal to one month's rent.

The tenant asks the landlord if he can pay half the security deposit in advance and the other half with the second month's rent. The tenant is unable to pay the security deposit in full until he receives his security deposit refund from his current landlord.

The landlord wants this applicant as a tenant and is willing to extend the credit.

To be cautious, the landlord structures receipt of the funds as payment of the entire security deposit and half of the first month's rent. The tenant will pay the remaining half of the first month's rent with payment of the second month's rent.

Thus, should the tenant fail to pay either the second month's rent or the remainder of the first month's rent when due:

- the landlord may serve a 3-day notice to pay rent or quit; and
- if not paid, deduct the amount from the security deposit as a last resort.

Conversely, consider a landlord who allows a tenant to allocate his initial payment on the lease to one full month's rent, with payment of the balance due on the security deposit spread over two or more months.

Here, should the tenant fail to pay the second installment of the security deposit, the default will not be a material breach of the lease or rental agreement. A material breach is necessary before a UD action based on service of a 3-day notice to perform can proceed to an eviction. A security deposit is not rent, although it is an amount "owed" to the landlord.

A tenant's breach must be material and go to the root of the lease or rental agreement, such as a failure to pay rent, before the landlord can justify service of a 3-day notice. A minor breach of the lease will not justify serving a 3-day notice to forfeit the tenant's right to possession. [**Baypoint Mortgage** v. **Crest Premium Real Estate Investments Retirement Trust** (1985) 168 CA3d 818]

PARTIAL PAYMENT AGREEMENT

Residential

DATE:_____________, 20______, at ____, California

Items left blank or unchecked are not applicable.

FACTS:

This partial payment agreement pertains to the collection of past due rent under a residential lease or rental agreement:

Dated __________________, at ____, California,

regarding leased premises referred to as:____

____

AGREEMENT:

1. Tenant has not paid the full rent due for the months of _________________________.

2. Landlord hereby accepts partial payment on the past due rent in the amount of . . . . $_______________

3. The balance of the unpaid rent owed by Tenant is . . . . $_______________

3.1 Plus a late charge for delinquency of . . . . $_______________

3.2 Plus a deferred rent processing charge of . . . . $_______________

3.3 Total deferred rent due, including additional charges, is the sum of . . . . $_______________

4. Tenant to pay the total deferred rent on or before _____________, 20______.

4.1 Rent to be paid by ☐ cash, ☐ check, or ☐ cashier's check made payable to Landlord.

4.2 Rent may be tendered by ☐ mail, or ☐ personal delivery to:

____ (Name)

____ (Address)

____

____ (Phone)

a. Personal delivery of rent will be accepted during the hours of ______ am to ______ pm on the following days: ____.

4.3 Rent may also be paid by deposit into account number ______________________________ at:

____(Financial Institution)

____(Address)

____

____

4.4 No grace period for payment of the deferred rent is granted to Tenant.

4.5 Delinquent payment of the deferred rent incurs a late charge of . . . . $_______________

5. If the deferred rent is not paid when due, a three-day notice to pay rent or quit may be served at any time.

6. No provision of the lease or rental agreement is affected by this agreement.

7. ____

____

____

I agree to the terms stated above.

Date:_______________, 20______

Landlord: ______________________________________

Agent: ____

Signature: _____________________________________

Address: ______________________________________

____

Phone:____

Fax: ____

I agree to the terms stated above.

Date:_____________, 20______

Tenant:____

Tenant:____

Signature: _____________________________________

Signature: _____________________________________

Address: ______________________________________

____

Phone:____

Fax: ____

Once the residential landlord accepts a partial payment of delinquent rent, the 3-day notice served on the tenant no longer states the correct amount which must be paid by the tenant to avoid losing his right to possession.

Any 3-day notice served on a residential tenant which overstates the amount of delinquent rent due at the **time of trial** on the UD action is invalid. The UD action in a residential eviction based on an overstated amount in the 3-day notice must fail. [**Jayasinghe** v. **Lee** (1993) 13 CA4th Supp. 33]

Thus, the residential landlord on accepting a partial payment of rent must serve another 3-day notice demanding payment of the remainder due on unpaid delinquent rent and file a new UD action if one has already been filed.

Nonresidential nonwaiver requirements

However, should a **nonresidential landlord** file a UD action and then accept a partial payment of rent, the landlord must then or previously have provided the tenant with notice that the acceptance of rent does not waive the landlord's rights, called a *nonwaiver of rights provision*. When the tenant receives a nonwaiver of rights notice on or before the landlord's acceptance of rent, the landlord can continue with the UD action and recover possession of the premises. [CCP §1161.1(c)]

Leases include a nonwaiver of rights provision which states the landlord's acceptance of partial rent does not constitute a waiver of the landlord's right to enforce any remaining breach of the lease. [See Form 552 §22]

Now consider a nonresidential tenant who defaults on a rent payment under a lease with a nonwaiver provision and fails to pay the rent before expiration of a 3-day notice to pay or quit. The notice to pay does not contain a notice of nonwaiver on acceptance of rent.

The nonresidential landlord files a UD action and then accepts a partial payment of rent without entering into any agreements, except to receipt the amount paid as being rent.

The tenant claims the landlord cannot now proceed with the UD action because he did not receive a notice of nonwaiver in the 3-day notice or on acceptance and receipt of the partial rent payment.

However, the nonresidential landlord may proceed with the UD action after receipt of partial rent. The nonwaiver provision in the lease agreement gives the tenant actual notice that the landlord's acceptance of any rent does not waive the landlord's rights. One such right is the right to proceed with a previously filed UD action. [**Woodman Partners** v. **Sofa U Love** (2001) 94 CA4th 766]

The 3-day notice or the partial payment agreement could include a nonwaiver provision to preserve the landlord's rights whether or not the lease contains the nonwaiver notice. A nonwaiver provision in a 3-day notice or partial payment agreement provides the landlord with the same right to proceed with the UD action as though the provision existed in the lease.

On accepting a partial payment of rent after a UD action has been filed, the nonresidential landlord amends the UD complaint to reflect the partial payment received and the amount now remaining due from the tenant. [CCP §1161.1(c)]

Get it in writing

Without a written partial payment agreement, the tenant might well claim the landlord who accepted partial rent:

- treated acceptance as an accord and satisfaction of all the rent due in a dispute over the rent amount; or
- waived the right to continue eviction proceedings, sometimes called *estoppel*.

The tenant might also argue the deferred payment schedule for the month in question was a permanent modification of the lease establishing a semi-monthly rent payment schedule.

When a residential or nonresidential landlord accepts a partial payment of rent, the use of the partial payment agreement is evidence which bars the tenant from later claiming the landlord waived valuable rights by accepting rent.

Residential partial payment agreement

The partial payment agreement entered into by a residential landlord and tenant on acceptance of a portion of the rent due is evidence of:

- the landlord's receipt of partial rent;
- the tenant's promise to pay the remainder of the rent by the rescheduled due date; and
- notification of the landlord's right to serve a 3-day notice on failure to pay the remaining balance. [See Form 559]

A partial payment agreement is not a notice to the tenant to pay the deferred portion of the delinquent rent or quit, which is required to establish an unlawful detainer and evict the tenant.

Consider a **residential tenant** who informs the landlord he is unable to pay the monthly rent due within the grace period, before the payment becomes delinquent.

The tenant offers to pay part of the rent prior to delinquency and the remainder ten days later.

Since the tenant is creditworthy, has not been delinquent in the past and the landlord wishes to retain the tenant, the residential landlord agrees to accept the partial payment.

However, to **avoid disputes** as to the amount of rent remaining due and when it will be paid, the residential landlord prepares and requires the tenant to sign a partial payment agreement formalizing their understanding.

Now consider a residential landlord who serves a 3-day notice and accepts a partial payment of rent before the notice expires. By accepting a partial payment, the residential landlord has rendered the 3-day notice invalid.

However, the residential landlord required the tenant to enter into a partial payment agreement when the rent was accepted.

The partial payment agreement will avoid any claims by the tenant about when the balance is due or that the landlord waived his right to serve another 3-day notice for the remainder of the delinquent rent.

Nonresidential partial payment agreement

The eviction rights reserved by a nonwaiver provision when a nonresidential landlord accepts partial rent are far less restrictive than for a residential landlord.

Before service of a 3-day notice to pay rent or quit on a **nonresidential tenant** who is delinquent in his rent payment, the nonresidential landlord can:

- accept partial payment of rent; and
- either concurrently or thereafter serve a 3-day notice, or agree not to serve a 3-day notice until the remainder of the rent is not paid as rescheduled. [See Form 558 §6.1]

When a 3-day notice has been served and the nonresidential landlord later accepts a partial payment of rent, the partial payment agreement acknowledging receipt of partial rent contains:

- the due date for payment of the delinquent rent remaining unpaid; and
- notice of the nonresidential landlord's right to file a UD action on nonpayment.

More importantly, a nonresidential landlord who accepts a partial payment of rent **after filing a UD action** and enters into a partial payment agreement with the tenant has notified the tenant he has not waived his right to continue the UD action and recover possession under the UD action previously filed.

Further, the nonresidential landlord could agree to reinstate the lease if the remainder of the delinquent rent is paid prior to the UD hearing date.

However, no agreement is necessary on acceptance of partial rent from a nonresidential tenant. The landlord can accept partial payment and immediately proceed with his next step in the eviction process — service of a 3-day notice or filing of the UD action or the UD hearing — if a nonwaiver provision is in a prior document, such as the lease.

Chapter 29 — Changing terms on a month-to-month tenancy

This chapter reviews the requirements for the landlord's 30-day notice to alter the terms in a tenant's month-to-month rental agreement.

Landlord's 30-day notice

A landlord and tenant enter into a month-to-month tenancy which includes an option to purchase the property which expires on termination of the month-to-month tenancy.

Later, the landlord serves the tenant with a 30-Day Notice of Change in Rental Terms stating the option to purchase will expire in 30 days, unless exercised by the tenant. [See Form 570 accompanying this chapter]

After the 30-day notice expires, the tenant, who is still in possession, attempts to exercise the option.

The landlord refuses to sell the property under the option, claiming the tenant's right to exercise the option to purchase no longer exists.

The tenant claims the option to purchase is binding for the duration of the tenancy, and the month-to-month rental agreement has not been terminated.

Can the tenant enforce the option to purchase?

No! The option expired unexercised on the running of the 30-day notice of change in rental terms.

The option to purchase was part of the rental agreement. Thus, on expiration of the 30-day notice cancelling the option, the option — as a set of terms in the month-to-month rental agreement — was eliminated.

Like any other provision contained or referenced in a month-to-month rental agreement, the option to purchase is part of the month-to-month tenancy, subject to change on 30 days written notice from the landlord. [**Wilcox** v. **Anderson** (1978) 84 CA3d 593]

30-day notice to change rental terms

All covenants and conditions in a residential or nonresidential month-to-month rental agreement, also called *provisions, clauses, terms, conditions, addendums, etc.*, for any type of real estate may be changed on 30 days written notice by the landlord. [Calif. Civil Code §827]

For example, a residential or nonresidential landlord under a month-to-month rental agreement can increase the rent (not to exceed 10% within 12 months) or shift repair and maintenance obligations to the tenant by serving a 30-Day Notice of Change in Rental Terms. [See Form 570]

To be enforceable, the 30-day notice must be served in the same manner as a 3-day notice to pay rent or quit.

However, only the landlord may unilaterally change the terms in a rental agreement. [CC §827]

A month-to-month tenant has no ability to alter the terms of his rental agreement, other than to terminate the tenancy and vacate. [CC §1946]

In rent control communities, a landlord or property manager must be fully apprised of how rent control ordinances affect their ability to alter provisions in leases and rental agreements.

30-day notice to increase rents

A landlord or property manager may serve a notice of change in rental terms under a periodic (month-to-month) rental agreement on **any day** during the rental period.

Once a notice of change in rental terms is served on a month-to-month tenant, the new terms stated in the notice immediately become part of the tenant's rental agreement. [CC §827]

However, the new rental terms stated in the notice do not take effect until expiration of the notice.

For example, a property manager prepares a 30-day notice of change in rental terms to be served on a month-to-month tenant to **increase the rent**.

The due date for the payment of rent is the first day of each month.

The tenant is properly served with the 30-day notice on the 10th of June. The tenant intends to remain in possession at the new rental rate.

Since June 11th is the first day of the 30-day **notice period**, the rent will not *begin to accrue* at the increased rate until July 11th — the day after the 30-day notice expires. However, rent for all of July is payable **in advance** on the first day of the month, including the number of days (21) affected by the rent increase.

The rent due and payable in advance for the calendar month of July will be prorated as follows:

- the old rate for the first ten days of the month; and
- the new rate for the remaining 21 days in the month of July.

Pro rata rent will be determined based on the number of days in the calendar month, unless the rental agreement contains a provision prorating rent on a 30-day month. [CC §14]

*Editor's note — Until January 1, 2006, unless extended, any residential landlord raising rent more than 10% within a 12-month period must furnish the tenant with a written 60-day notice of the rent increase. [CC §827; see **first tuesday** Form 574]*

Tenant's response to a change

On being served with a 30-day notice of a change in rental terms, the month-to-month tenant has three options:

- remain in possession and comply with the new rental terms;
- serve the landlord with a 30-day notice of intent to vacate and pay pro rata rent on the next due date for days remaining unpaid through the end of the 30-day notice to vacate; or
- remain in possession, refuse to comply with the rental terms and raise defenses, such as retaliatory eviction, in the resulting unlawful detainer (UD) action.

Editor's note — To prevail on a defense of retaliatory eviction, circumstances showing retaliation for the exercise of rights must exist.

30-DAY NOTICE OF CHANGE IN RENTAL TERMS

DATE:_____________, 20______, at ______________________________, California
To Tenant: ____

Items left blank or unchecked are not applicable.

NOTICE: A landlord must furnish the tenant with a written 30-day notice of any change in the terms of a month-to-month tenancy. If rent is raised more than 10% within a 12-month period on a residential tenant, a 60-day notice of the increase is required. [Calif. Civil Code §827; See **first tuesday** Form 574]

FACTS:

You are a Tenant under a rental agreement or expired lease
dated__________________, at ______________________________, California,
entered into by ____, Tenant,
and____, Landlord,
regarding real estate referred to as: ____

____

NOTICE:

Thirty (30) days after service of this notice on you, the terms of your tenancy on the real estate are hereby changed as checked below:

1. ☐ Rent shall be $_______________ ☐ monthly, or ______________________________,
payable in advance and due on the ____________________ day of the month.

1.1 Rent to be paid by ☐ cash, ☐ check, or ☐ cashier's check made payable to Landlord.

1.2 Rent may be tendered by ☐ mail, or ☐ personal delivery to:

____ (Name)

____ (Address)

____ (Phone)

a. Personal delivery of rent will be accepted during the hours of ______ am to ______ pm on the following days:____.

1.3 Rent may also be paid by deposit into account number ______________________
at: ____ (Financial Institution)

____ (.Address)

2. ☐ The common area maintenance charge shall be $_______________ per month, payable with each payment of rent.

3. ☐ Utilities now paid by Landlord to be paid by Tenant as checked:
☐ Gas ☐ Electricity ☐ Sewage and Rubbish ☐ Water ☐ Cable TV

4. ☐ Tenant to maintain and properly care for the lawns, gardens, tree, shrubs and watering system.

5. ☐ An additional security deposit of $_______________ is payable with the next rent payment.

6. ____

____

7. This notice affects no other terms of your tenancy.

Date:_____________, 20______

Landlord/Agent: ______________________________

Signature:______________________________

Phone: ______________________________

Fax: ______________________________

E-mail: ______________________________

Consider the tenant who receives the landlord's notice but does not wish to comply with changes in the rental terms. Accordingly, the tenant serves the landlord with a 30-day Notice of Intent to Vacate. [See **first tuesday** Form 572]

If the change is a rent increase, the tenant is liable for pro rata rent at the new rate for the days after the rent increase becomes effective up to the expiration of the tenant's notice to vacate — payable in advance on the due date for the next scheduled payment of rent, usually the first.

Rent control restrictions

Most rent control ordinances allow a landlord or property manager to increase the rent to:

- obtain a fair return on his investment;
- recover the cost of capital improvements to the property; and
- pass through the cost of servicing the debt on the property.

Thus, without further authority from the rent control board, a landlord can make general adjustments to rents in one of three ways:

- increase rent by the maximum percentage set by ordinance;
- increase rent by the maximum percentage of the consumer price index (CPI) as set by ordinance; or
- increase rent by the maximum amount previously set by the rent control board.

Landlords of newly constructed units or individual units (SFRs/condos) held out for rent may establish their own rental rates, subject to limitations if they are controlled by rent control ordinances established prior to 1995.

Chapter 30 Notices to vacate

This chapter presents the 30/60-day notices to vacate used by landlords and tenants to terminate month-to-month tenancies.

Termination of periodic tenancies

A tenant occupies a single-family residential property under a lease. The lease obligates the tenant to maintain the property's landscaping.

Soon the landlord receives complaints from surrounding property owners about excessive noise and a high number of visitors at the rental late at night. On more than one occasion, the police have responded to calls from neighbors regarding the noise.

Also, the city ordinance compliance department has given notice for the removal of disabled vehicles from the property.

On a drive-by inspection, the landlord also discovers the landscaping and lawn have deteriorated since the tenant has not watered.

While the tenant consistently pays the rent on time, the landlord feels the tenant must be evicted even though several months remain on the term of the lease. The tenant is creating a *nuisance* by interfering with his neighbors' use and enjoyment of their property and has failed to maintain the leased premises.

The landlord prepares and serves the tenant with a 30-day notice to vacate. The landlord avoids stating his reason for terminating the tenancy. [See Form 569 accompanying this chapter]

The tenant remains in occupancy of the premises after the 30-day notice expires and tenders the next rent payment on time.

The landlord refuses to accept the rent payment and files an unlawful detainer (UD) action to evict the tenant.

Can the landlord, subject to an unexpired lease which the tenant has breached, evict the tenant from the premises with a 30-day notice?

No! The tenant occupies the property under an unexpired lease. The landlord cannot terminate the lease by using a notice to vacate, much less use the notice to vacate to establish an unlawful detainer.

A **residential or nonresidential** 30-day notice to vacate the premises is only effective when used by a landlord or tenant to terminate a periodic tenancy. The term of the periodic tenancy does not matter, unless:

- the property is **residential** and the tenant has occupied the premises for **one year or more**, in which case the landlord, not the tenant, must use a 60-day notice to vacate [Calif. Civil Code §1946.1; see **first tuesday** Form 579]; or
- the property is **nonresidential** and the rental agreement calls for a greater or lesser period for notice, but not less than seven days. [CC §1946]

If agreed, a residential or nonresidential **lease** can provide for the tenant to terminate his occupancy prior to expiration of the lease on 30 days notice or any other period for notice, conditioned on the payment of a penalty for vacating prematurely. A lease is not controlled by the periodic tenancy rules prohibiting a forfeiture on the tenant's voluntary termination of a rental agreement.

Periodic tenancies extended/terminated

Unlike the extension of a lease, the 30-day rental period under a **month-to-month rental agreement** is *automatically extended* on the same terms.

Any landlord under a month-to-month rental agreement (or any other periodic rental agreement) may **interfere at any time** with the automatic renewal of the rental agreement and terminate the tenancy. Thus, the tenant's right to occupy under the periodic rental agreement is terminated by serving a 30-day notice to vacate.

However, if the property is residential and the tenant has resided on it for **one year or more**, then the landlord (not the tenant) is required to give the residential tenant a 60-day notice to vacate. [CC §1946]

Likewise, any tenant under a month-to-month rental agreement may at any time stop the automatic renewal process and terminate the tenancy by giving the landlord a 30-day notice of his intent to vacate the premises. [CC §§1946; 1946.1; see Form 572 accompanying this chapter]

An expired notice to vacate on a month-to-month tenancy, whether given by the tenant or the landlord, establishes a tenant's unlawful detainer (UD) should the tenant remain in possession. [**Palmer** v. **Zeis** (1944) 65 CA2d Supp. 859]

Thus, once the notice to vacate expires, the landlord may file a UD action to evict the month-to-month tenant without further notice.

Lease becomes a periodic tenancy

Consider a tenant who enters into a one-year lease of a unit in an apartment building.The lease term expires, and the tenant remains in possession of the unit. The tenant continues to pay rent monthly, which the landlord accepts.

Later, the landlord serves the tenant with a 60-day notice to vacate the property since the tenant has resided on the property for over one year. The tenant remains in possession of the property after the 60-day notice expires.

The landlord files a UD action to evict the tenant, claiming the tenant is now unlawfully detaining the unit.

The tenant claims he cannot be evicted based on a 60-day notice to vacate since he holds possession of the unit under a lease agreement, which was automatically extended for the same terms as the original lease when the landlord continued to accept rent after the initial lease expired.

Here, the notice to vacate is proper and the tenant can be evicted. The landlord's acceptance of monthly rent after the lease expired, without an extension or renewal agreement, establishes a month-to-month tenancy on the same terms as the lease. [CC §1945]

The lease term expired and the tenant now occupies the premises under a month-to-month tenancy based on all the provisions in the lease, except the term of the tenancy.

30-DAY NOTICE TO VACATE

(For Use by Residential Landlord)

DATE:_____________, 20______, at ____, California

To Tenant: ____

Items left blank or unchecked are not applicable.

NOTICE: A residential landlord may terminate a month-to-month tenancy by giving at least thirty (30) days written notice to the tenant, unless the tenant has occupied the unit one year or more, in which case at least a 60-day notice period is required. [Calif. Civil Code §1946]

FACTS:

You are a Tenant under a rental agreement or expired lease

Dated __________________, at ____,California,

entered into by ____, Tenant,

and ____, Landlord,

regarding real estate referred to as: ____

____

NOTICE:

1. This notice is intended as at least a thirty (30) day notice prior to termination of your month-to-month tenancy.

2. On or before _____________, 20______, a date at least thirty (30) days after service of this notice, you will vacate and deliver possession of the premises to Landlord or:____

____

3. Rent due and payable by you prior to the date to vacate includes prorated rent of $_______________, due ____________, 20______.

4. Landlord acknowledges the prior receipt of $_______________ as your security deposit.

4.1 Within 21 days after you vacate, Landlord will furnish you a written statement and explanation of any deductions from the deposit, and a refund of the remaining amount. [Calif. Civil Code §1950.5(f)]

4.2 Landlord may deduct only those amounts necessary to:

a. Reimburse for Tenant defaults in rental payments;
b. Repair damages to the premises caused by Tenant (ordinary wear and tear excluded);
c. Clean the premises, if necessary;
d. Reimburse for Tenant loss, damage or excessive wear and tear on furnishings provided to Tenant.

5. Landlord may show the leased premises to prospective tenants during normal business hours by first giving you written notice at least 24 hours in advance of the entry. The notice will be given to you in person, by leaving a copy with an occupant of suitable age and discretion, or by leaving the notice on or under your entry door.

6. Please contact the undersigned to arrange a time to review the condition of the premises before you vacate.

7. If you fail to vacate and deliver possession of the premises by the date set for you to vacate, legal proceedings may be initiated to regain possession of the premises and to recover rent owed, treble damages, costs and attorney fees.

8. The reason for termination is ____
(complete if required by rent control ordinance or Section 8 housing)

Date:_____________, 20______

Landlord/Agent: ______________________________________

Signature: ____

Address:____

____

Phone: ____

Fax: ____

For nonresidential landlords, a 30-day notice to vacate is sufficient to terminate the tenancy created by accepting rent under an expired nonresidential lease of any term.

Landlord's intent to evict

A landlord terminates a month-to-month tenancy by preparing and serving the tenant with the appropriate 30/60-day notice to vacate. If a breach exists, a 3-day notice to quit is used. [See **first tuesday** Forms 571 and 579]

A notice to vacate form used by a landlord contains:

- the name of the tenant;
- the address of the premises;
- a reference to the rental agreement or expired lease;
- a statement that the unit must be vacant within the applicable number of days (30 or 60) after service of the notice;
- the amount of pro rata rent to be paid when rent is next due; and
- a statement regarding the security deposit and its disposition.

A *forfeiture provision* is not properly included in any notice to vacate since no forfeiture can exist on its expiration — the tenancy merely expires when the notice expires, with no tenancy remaining to be forfeited.

Due to its contents, the landlord's notice to vacate form eliminates any confusion as to the amount of pro rata rent to be paid and when the rent is due. [See **first tuesday** Form 571 §3]

Tenant's intent to vacate

A tenant, residential or nonresidential, who intends to vacate and avoid further liability under a month-to-month rental agreement must give notice to the landlord of his termination of the tenancy. The tenant must give 30 days notice of his intent to vacate which may be done by letter personally delivered to the landlord or his agent, or sent by certified or registered mail. [CC §§1946; 1946.1]

Some landlords accept oral notice of the tenant's intent to vacate without reducing the notice to a writing signed by the tenant.

However, both the tenant and the landlord are better served when the landlord provides the tenant with a 30-Day Notice to Vacate form when entering into a rental agreement or when oral notice is given. The tenant will then have the correct paperwork to complete and deliver to the landlord or property manager. Use of a form lends certainty to the tenant's understanding of a critical event. [See Form 572]

A tenant's notice to vacate form documents and acknowledges:

- the tenancy is terminated on expiration of 30 days after service of the notice on the landlord or his manager;
- the tenant's intent to pay pro rata rent;
- the amount of the security deposit and an entitlement to an itemized statement for any deductions from the security deposit; and
- a statement relating to final review of the premises with the landlord or property manager for any cleaning and repairs.

30-DAY NOTICE TO VACATE

From Tenant

DATE:______________, 20______, at ____, California

To Landlord: ____

Items left blank or unchecked are not applicable.

NOTICE: Unless otherwise agreed, a Tenant may terminate a month-to-month tenancy by giving thirty (30) days written notice to the landlord. [California Civil Code §1946]

FACTS:

I am a Tenant under a lease or rental agreement

Dated ___________________, at____, California,

entered into by ____, Tenant,

and ____, Landlord,

regarding real estate referred to as: ____

____

NOTICE:

1. Within thirty (30) days after service of this notice, I will vacate and deliver possession of the premises to Landlord or____.

2. This notice is intended as a Thirty-Day Notice to terminate my month-to-month tenancy.

3. I understand:

3.1 I will owe prorated daily rent for any days in the 30-day period I have not prepaid rent.

3.2 I have previously given Landlord a security deposit of $________________.

3.3 Within 21 days after I vacate, Landlord will furnish me a written statement and explanation of any deductions from the deposit, and a refund of the remaining amount. [California Civil Code §1950.5(f)]

3.4 Landlord may deduct only those amounts necessary to:

a. Reimburse for Tenant defaults in rental payments;

b. Repair damages to the premises caused by Tenant (ordinary wear and tear excluded);

c. Clean the premises, if necessary;

d. Reimburse for Tenant loss, damage or excessive wear and tear on furnishings provided to Tenant.

3.5 Landlord may show the premises to prospective tenants by giving reasonable notice as called for in the lease or rental agreement. Twenty-four (24) hours will be presumed to be reasonable notice. Showings will only occur during normal business hours.

4. I will contact Landlord or Manager to review the condition of the premises before I vacate.

5. The reason for termination is ____.
(optional)

6. I have served this notice on Landlord or Manager by ☐ certified or registered mail, or ☐ personally.

This statement is true and correct.

Date:______________, 20______

Tenant:____

Signature: ____

Forwarding Address:__________________________________

____

Phone:____

Fax: ____

E-mail: ____

For Landlord/Agent's use:

Date Received ______________________________________:

If the tenant serves the landlord with a written 30-day notice to vacate and the **tenant fails** to vacate within 30 days after service, the landlord may immediately file a UD action. [Calif. Code of Civil Procedure §1161(5)]

Service of the notice to vacate

A notice to vacate may be served at any time during the month.

However, a **nonresidential landlord** and tenant may limit the right to serve the notice at any time by agreeing in the rental agreement that the 30-day notice to vacate cannot be served during the last six days of the month. This is not true for residential tenancies since service can be at any time. [CC §§1946; 1946.1(a)]

To be effective, the notice to vacate from a tenant or landlord must be served:

- in the same manner as a 3-day notice (in person, by substitution or post and mail); or
- by certified or registered mail, a method of service not available for 3-day notices to quit. [CC §§1946; 1946.1(e)]

Thus, the date of service is the date the notice is:

- personally served;
- handed to a person of suitable age and discretion and mailed;
- posted on the leased premises and mailed; or
- mailed by certified or registered mail.

The 30- or 60-day minimum period within which the tenant must vacate begins to run the day after the date of service, which is day one of the 30- or 60-day period. [CC §10]

If the day for expiration of the notice is a Saturday, Sunday or legal holiday, the tenant is not required to vacate until the next business day. [CCP §12a]

However, most notice to vacate forms give a **specific date** by which the tenant must vacate, which is at least 30 or 60 days after service of the notice. Thus, the day is not left to chance and not set as a weekend day or holiday.

Rent control limitations on eviction

If residential rental property is located in a rent control community, the landlord is limited in his ability to terminate the tenancy and evict the tenant.

Typically, evictions are allowed in rent control communities when:

- the tenant fails to pay rent or otherwise materially breaches the lease agreement;
- the tenant creates a nuisance;
- the tenant refuses to renew a lease;
- the tenant uses the residence for an illegal purpose; or
- the landlord or a relative will occupy the unit.

A landlord who owns properties subject to rent control and his property manager must make themselves aware of the local restrictions imposed on the eviction of tenants.

Good reason to evict

A landlord is not required to state his reasons, or even have good cause, for evicting a month-to-month tenant in a notice to vacate — with the exceptions of rent control and Section 8 housing.

When a tenant's rent is subsidized by the Department of Housing and Urban Development's (HUD) Section 8 housing program, the landlord must set forth the reasons for the termination in the notice to vacate, and the reasons must be for a good cause. [**Mitchell** v. **Poole** (1988) 203 CA3d Supp. 1]

However, under no condition may a landlord evict a tenant for the wrong reason.

The landlord may find himself not only unable to evict the tenant, but defending against the tenant's claim the eviction is:

- in retaliation for the tenant making official complaints about the property or against the landlord;
- based on discriminatory reasons, such as the tenant's ethnicity or marital status; or
- improper because of the failure to maintain the property in a habitable condition.

Chapter 31 — Dangerous on-site and off-site activities

This chapter presents the duty the landlord has to others, on or off the property, for dangerous on-site and off-site activities.

Duty to all to remove on-site dangers

A landlord must exercise *reasonable care* in the management of his property to prevent *foreseeable injury* to all others who may, for whatever reason, be on the premises. [**Rowland** v. **Christian** (1968) 69 C2d 108; Calif. Civil Code §1714]

If a person — a tenant, guest, invitee or trespasser — is injured due to the landlord's breach of his duty of care to remove or correct a known dangerous on-site condition, the landlord is liable. [CC §1714]

*Editor's note — The legal terms trespasser, invitee and licensee determine the rights of individuals who enter onto a parcel of real estate. Distinctions in the status of the person when on the property do not apply when determining a landlord's liability for injuries **suffered by others*** on the leased premises. [Rowland, supra]

The duty of care for others owed by the landlord **applies to all persons** on the property whether they enter the premises with or without permission or are mere social guests, unless the person is committing a felony on the property.

Conditions imposing responsibility

To **impose liability** on a landlord for an injury suffered by any person on the leased premises, several factors must be considered, including:

- the *foreseeability* of the type of harm suffered by the individual;
- the closeness of the *connection* between the landlord's conduct and the injury suffered;
- the *moral blame* attached to the landlord's conduct;
- the *public policy* of preventing future harm;
- the extent of the *burden* on the landlord and the *consequences* to the community of imposing a duty to exercise care to prevent the harm suffered; and
- the availability, cost, and prevalence of *insurance* for the risk involved. [Rowland, *supra*]

For example, the landlord with knowledge of a dangerous situation created by the presence of a tenant's dog is liable for injuries inflicted on others by the dog based on several of these factors.

The landlord's failure to remove from his property the dangerous condition created by the dog is **closely connected** to injuries inflicted by the dog.

The landlord is sufficiently aware of the dangerous condition created by the presence of the dog to **reasonably foresee** the possibility of injury to others.

Also, the landlord has the **ability to eliminate** or reduce the dangerous condition and prevent future harm by serving a 3-day notice to remove the dog or vacate. [**Uccello** v. **Laudenslayer** (1975) 44 CA3d 504]

Landlord's duty to inspect

The landlord must use reasonable care in the repair and maintenance of the leased premises to **prevent harm** to others.

To accomplish this level of safety through prevention of harm, the property must be inspected by the landlord whenever **entry is available** to the landlord.

Thus, before a landlord enters into, renews or extends a lease or rental agreement, a *reasonable inspection* of the leased premises for dangerous conditions must be completed as part of his duty of care to prevent injury to others.

If the landlord fails to inspect when the opportunity exists, the landlord will be **charged with knowledge** of any dangerous condition he should have discovered had he undertaken an inspection.

Consider a landlord and tenant who enter into a nonresidential lease agreement.

The lease allows the landlord to enter the premises for **yearly inspections**. Also, the tenant is required to obtain the landlord's approval before making any improvements.

With the landlord's consent, the tenant builds a roadside marketing structure and operates a retail produce business. The structure's concrete floor is improperly constructed and unfinished. Produce is often littered on the floor.

More than a year after construction, a customer slips and falls on produce littered on the floor and is injured.

The customer claims the landlord is liable for his injuries since the landlord's right to inspect the property puts him on notice of the dangerous condition created by produce falling on the improperly constructed and finished concrete floor.

The landlord claims he is not liable for the customer's injuries since he had no actual notice of the dangerous condition created by the temporary deposit of produce on the floor.

However, the landlord is liable for the customer's injuries if the construction of the concrete floor:

- is a dangerous condition; or
- poses a dangerous condition when littered with produce from a permitted use. [**Lopez** v. **Superior Court** (1996) 45 CA4th 705]

A landlord is required to **conduct an inspection** of the leased premises for the purpose of making the premises safe from dangerous conditions when:

- a lease is executed, extended or renewed; and
- the landlord exercises any periodic right to re-enter or any other control over the property, such as an approval of construction. [**Mora** v. **Baker Commodities, Inc.** (1989) 210 CA3d 771]

Here, the landlord would have observed the condition of the floor had he conducted the yearly inspection of the premises called for in the lease. Thus, the landlord is liable for *slip and fall* injuries when the condition of the floor is determined to be dangerous. [Lopez, *supra*]

A reasonable inspection

A landlord has a duty to inspect the leased premises when he **enters the premises** for any single purpose, such as maintenance, water damage or some other exigency which causes him to make an emergency visit.

While a landlord may enter the premises during the lease term, he is not required to make a thorough inspection of the entire leased premises. However, the landlord who enters will be charged with the knowledge of a dangerous condition if the condition would have been observed by a reasonable person. [Mora, *supra*]

A landlord of a leased premises containing **areas open to the public** will be liable for injuries caused by a dangerous condition in the public area if the condition would be discovered during an inspection by the landlord.

However, unless the landlord is responsible under the lease agreement for repair and maintenance of **nonpublic areas**, a landlord will not be liable for failing to discover a dangerous condition occurring in nonpublic sections of a leased premises.

The landlord is not required to expend extraordinary amounts of time and money constantly conducting extensive searches for possible dangerous conditions. [Mora, *supra*]

For example, a triple-net lease usually transfers all responsibility for maintaining and repairing the property to the tenant.

Under a triple-net lease, the landlord will not be liable for injuries to persons on the leased premises caused by a dangerous condition if:

- the dangerous condition came about after the tenant takes possession; and
- the landlord has no actual knowledge of the dangerous condition.

Editor's note — Often, landlords concerned about tenant maintenance of a leased premises will reserve the right to enter the premises every six months or once a year.

However, frequent inspections of a leased premises create a greater potential of liability for the landlord. Landlords often reserve the right to conduct frequent inspections to assure that the tenant is not damaging or wasting the premises and reducing its market value.

*The right to enter brings with it the **obligation to inspect** for dangerous conditions. Also, the landlord may tend to erroneously overlook possible dangerous conditions he can control which are connected to the tenant's use, not maintenance, of the property.*

Knowledge of dangerous conditions

Consider a landlord and tenant who enter into a residential rental agreement which gives the tenant permission to keep a German Shepherd on the premises.

After the tenant takes possession of the property, the landlord never visits the premises and never sees the dog.

Later, an employee from a utility company enters the yard and suffers injuries when he is attacked by the tenant's dog.

The utility company employee seeks to recover money from the landlord as compensation for the injuries inflicted on him by the tenant's dog. The employee claims the landlord should have known the dog is dangerous since German Shepherds are a breed with the propensity for viciousness.

Is the landlord liable for the employee's injuries?

No! The landlord did not have knowledge the tenant's dog was vicious and presented a danger to others. [**Lundy** v. **California Realty** (1985) 170 CA3d 813]

A landlord's obligation to prevent harm to others arises only when the landlord is aware of or *should have known* about the dangerous condition and failed to take preemptive action.

For instance, the landlord receiving complaints from neighbors about the behavior of a tenant's dog may deduce the dog is a dangerous condition, even if the dog has not yet injured anyone.

Editor's note — The landlord's duty to protect others from an injury inflicted by a dog does not yet include asking the tenant if his dog is dangerous.

However, it is feasible the legislature could enact a law or the courts could impose a duty of inquiry on landlords when authorizing the tenant to keep a dog on the premises.

Thus, the pet authorization provision in the lease or rental agreement could include a declaration that the authorized pet is not dangerous.

Further, the owner of a dog is neither civilly nor criminally liable for a dog bite suffered by a person who enters the dog owner's property, lawfully or otherwise, unless the person is invited onto the property by the owner of the dog, is an employee of a utility company, a police officer or a U.S. mailman. [CC §3342(a)]

Landlord should have known

Now consider a landlord who leases nonresidential property to a tenant who operates a retail sales business on the property.

The tenant keeps a dog on the premises and posts a "Beware of Dog" sign. A newspaper article written about the dog's vicious temperament is also posted on the premises.

The landlord visits the leased premises several times a year and knows the dog is kept in the public area of the premises.

After the lease is renewed, a delivery man is attacked and injured by the dog.

The delivery man claims the landlord must compensate him for his injuries since the landlord has a duty to inspect the property and ensure it is safe for members of the public to enter.

The landlord claims he is not liable since he was personally unaware the dog was dangerous.

Is the landlord liable for the delivery man's injuries?

Yes! The landlord owes a duty to the delivery man as a member of the public to:

- exercise reasonable care in the inspection of his property **to discover** dangerous conditions; and

- remove or otherwise eliminate the dangerous condition that may be created by the presence of a dog.

The injured person can recover when the landlord is **personally unaware** of the dog's vicious propensities since a reasonable inspection of the premises on renewal of the lease would have revealed to the landlord the newspaper article and the "Beware of Dog" sign. [**Portillo** v. **Aiassa** (1994) 27 CA4th 1128]

Also, it is foreseeable that a guard dog kept on a premises during business hours could injure someone.

Further, the landlord's failure to require the tenant to remove the dog from the premises on discovery that the dog constitutes a dangerous condition is closely connected to the delivery man's injuries.

The landlord had control over the condition, as he could serve a 3-day notice on the tenant requiring the tenant to remove the dog from the premises during business hours or vacate the premises.

Editor's note — In Portillo*, the court held **moral blame** is attached to the landlord's conduct because of his failure to remove a condition he should have known was dangerous and over which he had control.*

Also, a landlord can often remove a dangerous condition by merely exercising his responsibility to make repairs which will eliminate the condition. However, a dangerous condition caused by a tenant's activity may require a 3-day notice ordering the tenant to correct or remove the dangerous condition, or vacate the premises. [See **first tuesday** Form 576]

On-site danger leads to off-site injury

Now consider a landlord and tenant who enter into a rental agreement for a residential dwelling.

The agreement allows the tenant to keep dogs on the premises.

After the tenant occupies the residence, the landlord visits the premises monthly to collect the rent payments. During his visits, the landlord observes the dogs. The landlord is aware of the dogs' vicious nature.

One day, a neighbor and his dog are attacked and injured by the dogs two blocks away from the leased premises.

The neighbor demands the landlord pay for losses resulting from the injuries. The neighbor claims the landlord owes him a duty of care to prevent injuries arising from dangerous animals the tenant keeps on the landlord's premises.

The landlord claims he is not liable since the injuries occurred off the leased premises.

Here, the landlord is liable for the off-site injuries since the landlord:

- was *aware* of the vicious propensities of dogs housed on his premises; and
- had the ability to remove the dangerous condition by serving a 3-day notice on the tenant to remove the dogs or vacate the premises. [**Donchin** v. **Guerrero** (1995) 34 CA4th 1832]

The landlord's liability for injuries inflicted by a tenant's dog off the premises is the same as his liability for injuries inflicted by the dog which occur on the premises.

While the landlord did not have control over the property where the injury occurred, the landlord did have control over the tenant's right to keep and maintain a known dangerous condition — the dogs — on the premises.

The landlord's failure to have dangerous dogs removed from the premises caused the injuries suffered by the neighbor.

The injury would not have occurred but for the landlord allowing the dogs, which he knew to be vicious, to remain on the premises he controlled. [Donchin, *supra*]

Tenant's dangerous on-site activity

Consider a landlord who is aware the tenant of his single-family rental occasionally discharges a firearm in the backyard.

One day, a bullet fired by the tenant enters the backyard of the neighboring residence and kills the neighbor.

The neighbor's spouse makes a demand on the landlord for her losses resulting from her husband's death. The spouse claims the landlord breached his duty to individuals located on neighboring property by failing to exercise care in the management of his property when he did not remove the known dangerous activity from the premises.

Is the landlord liable for the neighbor's death which occurred off the premises?

Yes! Even though the injury occurred off the leased premises, the landlord is liable since the landlord:

- knew of the dangerous on-site activity carried on by the tenant which inflicted the injury; and
- had the ability to eliminate the dangerous condition by serving a 3-day notice on the tenant to refrain from discharging the gun or quit the premises. [**Rosales** v. **Stewart** (1980) 113 CA3d 130]

Thus, the landlord had a duty to prevent the tenant from continuing to fire the gun on the premises.

The landlord is liable for an injury resulting from a known dangerous condition or activity maintained or occurring on his property which he has the ability to remove, regardless of whether the injury from the on-site activity is suffered on or off the leased premises.

However, had the tenant left the premises with his gun and then shot and killed an individual, the landlord would not be liable. [**Medina** v. **Hillshore Partners** (1996) 40 CA4th 477]

Failure to avoid obvious dangers

Some dangerous conditions are obvious to persons entering or using the premises which impose a duty of care on the person to avoid injury to themselves.

For example, a person wearing cleated shoes walks on a concrete path alongside of which is a rubber walkway for use to prevent slip and fall injuries. The person wearing cleated shoes walks on the concrete path and slips, injuring himself in the fall. A sign does not exist to explain the danger of the person's activity.

Here, a landlord has no duty to warn or guard others against a dangerous condition that is obvious. [**Beauchamp** v. **Los Gatos Golf Course** (1969) 273 CA2d 20]

While a landlord must compensate others for injuries caused by his failure to use skill and ordinary care in the management of his property, the liability has its limits.

A person, who willfully or by his own **lack of ordinary care** brings an injury upon himself, exonerates the landlord, wholly or in part, from liability. [CC §1714]

Thus, a person has a duty of care to himself to be sufficiently observant and keep himself out of harm's way.

When the injured person's lack of care for himself contributes to his injury, recovery for his losses is limited to the percentage of the negligence attributed to him, called *comparative negligence*. The money losses recoverable by the injured person will be diminished in proportion to the percent of negligence attributable to the injured person for causing his own harm. [**Li** v. **Yellow Cab Company of California** (1975) 13 C3d 804]

Further, consider a trespasser who enters into or onto property illegally and fails to conduct himself with care to avoid harming himself, called *negligence*.

When the trespasser is negligent in exercising care in his conduct to prevent harm to himself while entering or moving about the property, any losses recoverable by the injured trespasser will be reduced by the percentage amount of negligence attributed to his injury. [**Beard** v. **Atchison, Topeka and Santa Fe Railway Co.** (1970) 4 CA3d 129]

Further, the landlord's liability will be limited if the trespasser was in the process of committing a felony on the property when he was injured. [CC §847]

Not a dangerous condition

Now consider a person who enters leased nonresidential property and wants to look inside the building.

Next to the building, below a window, stands a vat of acid maintained by the business authorized to operate on the leased premises. The vat is covered with plywood for the purpose of keeping out dirt and dust.

In order to see through the window, the person climbs up and steps onto the plywood cover which immediately collapses. The person falls into the vat and suffers injuries.

The person attempts to recover money from the landlord for losses suffered from his injury.

Here, the landlord is not liable for the person's injuries since the vat is not a dangerous condition which presents a risk of harm. The vat of acid is an integral part of the business run on the leased premises and is not a danger to any person who conducts himself with care around the vat.

Thus, the injured person undertook the risk of harm to himself by climbing on top of the vat and creating the dangerous situation which led to his injuries. [**Bisetti** v. **United Refrigeration Corp.** (1985) 174 CA3d 643]

Editor's note — In Bisetti*, the injured person happened to be a trespasser.*

Consider a landlord of an apartment complex used by gang members as a hangout and base from which they commit criminal offenses when off the premises. One of the gang members is a named tenant.

The tenants and law enforcement officials complain to the landlord about the gang. However, the gang members do not harm or pose a threat of danger to the tenants.

Later, a pedestrian walking past the complex in the public right of way is chased by the gang members. One of the gang members, who is not the tenant, shoots and kills the pedestrian on a street adjacent to the complex.

The spouse of the pedestrian claims the landlord is liable for the death since he failed to remove the dangerous condition, the presence of gang members, on his premises.

However, the landlord does not have a duty to protect members of the public who use adjacent public streets from assaults by gang members who congregate on his leased premises. [Medina, *supra*]

The congregation of gang members on the leased premises is not itself a dangerous condition. The gang members do not pose a physical threat to others of which the landlord is aware.

Thus, the landlord's failure to take steps to prevent the gang members from congregating on the leased premises is not the cause of the off-site shooting of a pedestrian by one of the gang members.

Again, the landlord is not liable for injuries that occur off the leased premises, since the landlord has **no control over the activities** of individuals or tenants while they are on public property, only when they are on his property. [Medina, *supra*]

Dangerous off-site conditions

Now consider a landlord who leases a residence to a tenant. The residents of the neighboring property own a dog the landlord knows to be vicious.

The neighbor brings his leashed dog onto the leased premises. The neighbor invites the tenant's child to pet the dog.

The dog breaks free from the leash and attacks the child, causing injuries.

The tenant claims the landlord is liable for the injuries since the landlord failed to warn him of the dangerous condition created by the neighbor's vicious dog.

Is the landlord liable for injuries inflicted on-site by the neighbor's dog, which he knew was vicious?

No! The dangerous condition was not maintained on the leased premises. Thus, the landlord has no control or authority himself to remove the dangerous condition from the neighbor's property. [**Wylie** v. **Gresch** (1987) 191 CA3d 412]

While a landlord owes a duty to others to remove a dog from his property which he knows to be dangerous, he does not have a duty to warn his tenants of the presence of vicious animals located on other properties in the neighborhood.

The landlord's failure to protect the tenant by warning him about the neighbor's dog did not create a dangerous condition on the leased premises which caused the tenant to be injured.

A landlord's duty to correct or prevent injury from dangerous conditions does not extend to the dangerous conditions which exist off the premises. [Wylie, *supra*]

While the landlord does have a duty to make the leased premises safe by removing dangerous on-site conditions and properly maintaining the premises, he is not the insurer of the tenant's safety from off-site hazards. [**7735 Hollywood Boulevard Venture** v. **Superior Court** (1981) 116 CA3d 901]

Off-site injuries under landlord control

The public right of way for a street fronting a leased premises includes part of the lawn in front of the premises, located between the street curb and the property line. The landlord maintains the entire lawn up to the curb.

A water meter is located on the lawn in the street right of way. Several tenants inform the landlord the water meter box is broken and needs repair.

A tenant trips on the broken water meter box and suffers injuries.

The tenant makes a demand on the landlord for losses caused by his injuries, claiming the landlord has a duty to eliminate dangerous conditions located in the public right of way within the lawn maintained by the landlord.

The landlord claims he is not liable since the water meter box is not located on his property and the landlord does not own or control the meter box.

However, the landlord is liable for the injuries suffered by the tenant caused by dangerous conditions — the broken water meter box — located in a public right of way surrounded by a lawn created and maintained by the landlord. [**Alcaraz** v. **Vece** (1997) 14 C4th 1149]

Also, a landlord or other property owner who installs and maintains trees adjacent to or in the lawn area between the public sidewalk and the street-side curb owes a duty of care to avoid injuring pedestrians by hazards created by the trees he maintains.

For example, trees planted and maintained by the property owner grow and eventually produce roots which extend under the sidewalk and crack and uplift it. The owner is aware of the hazard created but undertakes no steps to have the hazardous condition repaired or replaced.

Here, the owner has taken control over the off-site area containing the public sidewalk and will be liable to any pedestrian who is injured due to the hazard created by the roots of trees he maintains since the trunks of the trees are located on his property. [**Alpert** v. **Villa Romano Homeowners Association** (2000) 81 CA4th 1320]

Chapter 32 — Rates affecting real estate

This chapter is an overview of the rates and figures which impact real estate sales, leasing and financing decisions.

The influence of federal reserve policies

The rates reviewed here are commonly used in real estate transactions. For instance, the Consumer Price Index (CPI) is used as an inflation index to adjust rents, allowing the landlord to retain his purchasing power from year to year.

The components of the various interest rates, index figures and the Federal Reserve's policies used in an attempt to control the economy are often confused or unknown to the reader.

The discount rate

The discount rate is the interest rate the Federal Reserve charges banks and thrifts who borrow funds directly from the Fed to maintain reserve requirements. [See Figure 1]

The discount rate is important to private money lenders who are:

- not licensed real estate brokers; and
- do not arrange their loans through real estate brokers.

The discount rate is a component of the interest rate limits imposed by usury laws on non-brokered, private money real estate loans. The discount rate component for usury limits is set each month and is the rate effective on the 25th day of the previous month.

For example, on August 15, 1999, the discount rate rose from 4.50% to 4.75%. Thus, the September 1999 discount rate was 4.75%.

The discount rate for the life of the loan is the rate for the month the loan agreement is entered into.

The maximum annual interest rate on non-exempt loans secured by real estate is the greater of:

- 10% per year; or
- the discount rate plus 5%. [California Constitution, Article XV §1]

The discount rate for the applicable month is useful to the non-exempt lender when the discount rate exceeds 5%.

Federal funds

Federal funds are overnight funds lent in the federal funds market by one bank with excess reserves to another bank with insufficient reserves.

The Federal Reserve influences the movement of the federal funds rate by affecting the supply of bank reserves, through buying or selling government securities, typically one-year T-bills.

Figure 1

Real estate related rates
Actual figures: current, last month, a year ago

6-month Treasury bill average auction rate

Current	Month ago	Year ago
12/9/05	11/11/05	12/10/04
4.16%	4.16%	2.37%

ARM interest rate equals 6-month T-bill rate (at time of adjustment or an average of several prior rates) plus the lender's profit margin.

Treasury securities average yield — 1-year constant maturity

Current	Month ago	Year ago
12/9/05	11/11/05	12/10/04
4.35%	4.35%	2.60%

ARM interest rate equals T-bill yield plus the lender's margin. The index is an average of T-bill yields with maturities adjusted to one year.

Cost-of-funds index 11th F.H.L.B.B. District
(for Oct. 2005)

Current	Month ago	Year ago
3.07%	2.97%	1.96%

ARM interest rate equals cost-of-funds plus the lender's profit margin. Current index reflects cost-of-funds two months prior.

Prime rate

Current	Month ago	Year ago
12/7/05	11/9/05	12/8/04
7.0%	7.0%	5.0%

The prime rate is used by banks to price short-term business loans and set ARMs tied to the prime rate.

Discount rate — Federal Reserve Bank of San Fransico

Current	Month ago	Year ago
12/13/05	11/1/05	12/14/04
5.25%	5.0%	3.25%

Usury law limits the annual interest yield on non-exempt loans to 10% or the discount rate plus 5% whichever is greater. The discount rate is charged on loans made by the Federal Reserve bank to its members.

12-month Treasury Average

Current	Month ago	Year ago
Nov. 05	Oct. 05	Nov. 04
3.478%	3.326%	1.773%

ARM interest rate equals T-bill average yield plus the lenders margin. The index is an average of the one-year T-bill rates for the past 12 months.

Average 30-yr conventional commitment rate for West Region for week ending:

Current	Month ago	Year ago
12/15/05	11/17/05	Dec. 04
6.30% (.5 pts)	6.37% (.6 pts)	5.68% (.6 pts)

The average 30-yr commitment rate is the rate at which a lender commits to lend mortgage money in the West Region as reported by FHLMC.

London Inter-Bank Offered Rate

1 month	6 month	1 year
4.295%	4.579%	4.737%

ARM interest rate equals the LIBOR rate plus the lender's margin. The rate is set by the banks in London, England.

10-year T-bonds — average market yield for week ending:

12/9/05	11/11/05	12/10/04
4.52%	4.60%	4.19%

The rate is a leading indicator of the direction of future FHLMC rates. The rate is comprised of the level of word wide demand for the dollar and anticipated future domestic inflation

Applicable Federal Rates
(monthly payments)
December 2005

Short (up to 3 yrs.)	Medium (3 to 9 yrs.)	Long (9 + yrs.)
4.25%	4.43%	4.68%

Determines minimum interest rates imputed interest rates on non-exempt carryback financing. The AFR category is determined by the carryback due date.

Consumer Price Index — Urban Consumer (CPI-U)
(1982-84 = 100)

San Francisco		Los Angeles	
Nov. 2005	205.9	Nov. 2005	205.6
Nov. 2004	200.3	Nov. 2004	196.9
Annual Change	+2.81%	Annual Change	+4.42%

The CPI is used in leases to adjust rents **San Diego** CPI-U is published semiannually and figures are 163.7 for the first half of 1997 and 163.7 for the second half of 1997, a 1.1% increase over the same period last year.

The San Francisco Index is issued bi-monthly.

When the Fed wants to tighten monetary policy to cut inflation, it will sell government securities to reduce bank reserves, causing the federal funds rate to increase.

An increase in the federal funds rate will cause rate increases in other short-term money instruments such as treasury bills, certificates of deposits (CDs) and repurchase agreements (RPs).

Both the discount rate and the federal funds rate are tools used by the Federal Reserve to control short-term interest rates. Recent increases in short-term rates were spurred by the Federal Reserve Board's perception that higher inflation looms in the future due to an excessive demand for goods and services.

By increasing the short-term rates, the Fed intends to slow down the economy by limiting the availability of credit.

6-month and 1-year T-bills and the 11th District Cost-of-Funds

The figures for six-month and one-year T-bill indexes are based on the sale of T-bills through the money markets. In contrast, the 11th District Cost-of-Funds is the average cost of funds for 11th District savings institutions. The six-month T-bills, the one-year T-bills and the 11th District Cost-of-Funds are all used as indexes for adjustable rate mortgages (ARMs).

Rates on one-year T-bills are more volatile and rise and fall faster than the steadier 11th District Cost-of-Funds.

Entering periods of increasing rates, such as late 1998 and beyond, lenders prefer the faster upward movement of the one-year T-bill indexes for increasing their yield and maintaining asset value.

Prime rate

Also used as an index for ARMs is the prime rate, to which a margin of two or three percent is added for monthly or semi-annual adjustments.

The prime rate is a base rate used by banks to price short-term business loans. In addition to ARMs, lines of credit are commonly indexed to the prime rate.

As short-term interest rates are increased, so will the prime rate, which is administratively set by individual banks, since the bank's cost of funds increases.

CPI, rents and resale pricing

Inflation is a rise in the price level of goods and services demanded in the economy. The Consumer Price Index (CPI) is the index maintained by the federal government to measure the inflation level. In real estate, the CPI for all urban consumers (CPI-U), is often used to calculate periodic rent adjustments.

When using the CPI-U for rent adjustments, the owner is compensated for the loss in the dollar's purchasing power.

Further, long-term interest rates are influenced by the expected future rate of inflation. The long-term interest rates reported on the rate page are:

- the average 30-year conventional commitment rate for the Western region as reported by Freddie Mac;
- Moody's Corporate bonds; and
- 10-year T-bonds.

The Federal Reserve does not have any direct control over long-term interest rates. However, the Fed's attempts to control inflation through its monetary policy influence the expected future inflation rates, which in turn are reflected in long-term interest rates.

For example, the Fed began to increase short-term interest rates in mid-1999 to fight what the Fed perceived to be inflationary pressures in the economy brought about by demand and pricing (and the recovery of foreign markets, weakening dollar, etc.).

Due to a general view within the bond market that inflationary pressures existed in the national economy, and controversy over whether the Fed had the desire or tenacity to control the perceived inflationary pressures, long-term interest rates began to rise — and rose rapidly from October 1998 through fall 1999.

However, with short-term interest rates steadily increasing, inflationary fears are lessening and long-term interest rates stabilize and drop.

The AFR's

Imputed interest reporting establishes the Applicable Federal Rate (AFR) of interest for debt carried back by a seller on an installment sale. An interest rate on a carryback note which is below the AFR triggers imputed interest reporting to the IRS. Thus, profit is shifted to interest income.

The imputed rate is the lesser of the AFR for the month the purchase agreement is entered into, or 9%.

Twelve AFRs are set monthly by the Internal Revenue Service. The due date of the note and the periodic payment schedule determine the note's minimum reporting rate. For example, notes due in three or less years, payable quarterly, fall into the short-term AFR category at its quarterly rate.

Chapter 33 A lender's loan commitment

This chapter discusses the unenforceability of a lender's oral or written commitment to fund a loan.

No responsibility for oral or conditional promises

A businessman seeks a loan from an institutional or portfolio lender to upgrade and expand production facilities, and construct improvements on real estate he owns and uses in his business. The owner has a long-standing business relationship with the lender, having borrowed from them several times in the past.

The lender's loan officer orally assures the owner they will provide long-term financing to refinance high-interest, short-term debts which the owner will incur to improve his facilities, called a *take-out loan*. Relying on the lender's oral assurances, the owner enters into a series of short-term loans and credit arrangements with other lenders and suppliers, and begins the planned improvements.

The lender's loan officer visits the owner's plant during the construction and placement of equipment. The officer comments favorably on the work in progress and again assures the owner the lender will provide the long-term financing sought by the owner.

When completed, the owner makes a demand on the lender to fund the permanent financing. The lender refuses, informing the owner the business no longer has the value needed to justify the long-term financing since operating costs and a recession in the market has decreased the value of the owner's facilities.

The owner is unable to obtain refinancing elsewhere, and the business collapses under the weight of the short-term debts. The owner seeks to recover his money losses from the lender based on the lender's breach of its commitment to provide financing.

Can the owner recover damages from the lender?

No! The lender never entered into an enforceable loan commitment. Nothing was placed in writing or signed by the lender which **unconditionally committed** the lender to the specific terms of a loan.

Even though the lender orally assured the owner a loan would be funded, and despite the owner's existing business relationship with the lender, the owner was not justified in relying on the lender's oral commitment to fund a loan. [**Kruse** v. **Bank of America** (1988) 202 CA3d 38]

The *Kruse* court chose to ignore standard lending practices between banks and their customers. Lenders rarely make written loan commitments, and when lenders do, they are only federally mandated non-binding disclosures on single family residences (SFRs) under Regulation Z, also known as the Truth in Lending Act (TILA). Commercial lenders customarily process applications and prepare loan documents which are signed by the borrower alone. The lender orally advises the borrower whether the loan has been approved, but signs nothing. The first and only act committing the lender is its actual funding of the loan — at the time of closing.

Thus, until the lender literally delivers funds and a closing occurs, it can back out of the oral loan commitment at any time, without liability.

As a result, the balance of power is entirely with the lenders. Lacking support from the brokerage community to right the balance of power, borrowers are forced to rely on unenforceable oral promises when making business decisions, negotiating real estate transactions and undertaking construction or development projects.

When a lender breaches its oral commitment, as in *Kruse*, the borrower's reliance on anything less than an **unconditional written loan commitment** is not legally justified — even though the borrower had no other realistic choice than to rely on the lender's oral promises.

Prudent borrowers and their agents submit loan applications to more than one lender to help guard against last-minute surprises.

Commitment upon commitment

The only other course of action a borrower could reasonably undertake is to purchase a **written loan commitment**, paying for the assurance funds will be advanced on the borrower's request. However, these commitments, which are *put options,* are always conditional. The lender is allowed to deny a loan even after delivering a written loan commitment to the borrower — again, without liability.

For example, a borrower seeks a loan to purchase real estate and the business opportunity located on the premises. The borrower pays $10,000 for a **written conditional loan commitment** from a lender — a letter signed by the lender indicating the lender's intention to fund the loan, based on the satisfaction of a number of conditions, including:

- an appraisal of the personal property and real estate which is to secure the loan;
- the property securing the loan must be free of other encumbrances;
- the seller, who is carrying back a second, must approve the terms of the loan agreement;
- the borrower must deliver copies of all documents affecting the lender's decision, such as security agreements, guarantees, title reports, trust deeds, and leases, for the lender's approval; and
- approval of the loan by the lender's senior committee.

Later, the lender **verbally assures** the borrower the loan will be funded, stating the members of the senior committee have all approved the loan and all other conditions have been met.

However, the lender does not deliver a final written commitment or waiver of the conditions to the borrower. Ultimately, on demand from the borrower for the funds, the lender refuses to fund the loan.

The borrower is able to obtain another loan from his back-up lender, but on less favorable terms. The borrower seeks to recover money damages from the lender which denied the borrower's loan application, claiming the lender breached its written loan commitment.

The lender claims it did not breach its written commitment since the commitment it signed was conditional, and the lender never delivered a waiver or final written loan commitment.

Can the borrower recover money damages from the lender?

No! Even though the borrower paid the lender for a written conditional loan commitment, the lender never made a final and unconditional written commitment. Thus, the lender escapes liability for failure to perform on its commitment, despite oral assurances to the borrower it would fund the loan agreed to in writing. [**Careau & Co.** v. **Security Pacific Business Credit, Inc.** (1990) 222 CA3d 1371]

Once again, the door is held open for the lender to back out at the last minute. The *Kruse* and *Careau & Co.* cases are part of a larger trend in the courts to extend as much protection and power as possible to lenders, largely as a result of the financial difficulties experienced by mismanagement of the entire banking industry in the 1980s.

Since 1982, courts have become increasingly reluctant to decide against lenders, for fear they might bear blame for pushing the banking industry into collapse. Thus, courts, like legislators, are willing to allow unfair results for borrowers, rather than applying law imposing financial burdens on bankers based on their commitments — which the courts could do (estoppel, detrimental reliance, waiver, etc.).

The balance of power will someday shift back to the borrower as it shifted from borrower to lender in the early 1980s. However, with the financing industry still unstable due to the turn-of-the-millennium disruption of overabundant mergers and inattention to risk management, it is difficult to predict when the days of the pro-lender court will end.

Chapter 34 Equity purchase sale-leaseback

This chapter digests the legal and tax consequences which arise due to the recharacterization of a sale-leaseback arrangement as a loan when the leaseback is coupled with a repurchase option.

The home equity sales scheme

An *equity purchase* (EP) transaction is highly regulated and occurs when an owner-occupied, one-to-four unit residential property in foreclosure is acquired from the owner-occupant by a buyer for rental, investment or dealer purposes, called an *EP investor*. Conversely, an EP transaction does not occur and the EP rules do not apply if the buyer acquires the property to occupy it as his personal residence.

Equity purchase statutes apply to all EP investors regardless of the number of EP transactions the investor completes. The investor need not be **in the business** of purchasing homes in foreclosure for the EP statutes to apply to him. [**Segura** v. **McBride** (1992) 5 CA4th 1028]

The EP investor and all brokers involved must use a written agreement containing statutory EP notices. Failure to use the correct forms subjects the EP investor and the brokers to liability for all the losses incurred by the seller-in- foreclosure, plus penalties. [Segura, *supra*]

Prior to closing the sale, a **seller-in-foreclosure** has a statutory five-business day *right to cancel* the EP agreement he has entered into with an EP investor, and avoid the sale entirely.

The seller-in-foreclosure's five-business day **right to cancel** does not begin to run until proper notice of the cancellation period is given to the seller. [Calif. Civil Code §§1695.4; 1695.5]

Further, and until expiration of the seller-in-foreclosure's right to cancel the transaction, the **EP investor** may not:

- **accept a conveyance** from the seller of any interest in the property;
- **record a conveyance** with the county recorder of the residence signed by the seller;
- **transfer an interest** in the property to a third party;
- **encumber any interest** in the residence; or
- **hand the seller** a "good faith" deposit or other consideration. [CC §1695.6]

In negotiations with the seller-in-foreclosure, the **EP investor** may not misrepresent:

- the **value of the property** in foreclosure;
- the **net sales proceeds** the seller will receive on closing escrow;
- the **terms of the purchase agreement** or any other document the EP investor uses to induce the seller to sign; or
- the **rights of the seller** in the EP transaction. [CC §1695.6(d)]

Cancellation of the purchase agreement by the seller-in-foreclosure is **effective on delivery** of the signed written notice of cancellation to the EP investor's address in the purchase agreement.

When the cancellation period expires for lack of cancellation, the purchase agreement becomes enforceable and escrow can be closed — unless other contingencies exist.

After escrow closes, and while the EP investor remains the owner, his title is subject to the seller-in-foreclosure's **right of rescission** for two years. The recision must be based on some *unconscionable conduct* of the EP investor. The seller's two-year right to *rescind and recover* the property from the EP investor cannot be waived by the seller. [CC §§ 1695.10; 1965.14]

An EP investor who violates the prohibitive five-day cancellation period or takes *unconscionable advantage* of the seller-in- foreclosure will be subject to imprisonment and a fine no greater than $25,000 or both for each violation. [CC §1695.8]

Also, any broker representing an EP investor as the **buyer's agent** must provide the seller-in-foreclosure with a writing stating under **penalty of perjury** that the broker is:

- a licensed real estate broker; and
- bonded by a surety insurer for twice the property's fair market value. [CC §1695.17(a)]

A mortgage or tenancy on breach?

A homeowner defaults on loan payments secured by a trust deed on his home. The lender begins foreclosure proceedings by recording a Notice of Default (NOD).

The NOD recording is picked up by a foreclosure reporting service. The service's subscribers are then advised of the NOD. An equity purchase (EP) investor tracking NOD recordings contacts the homeowner, intending to investigate the property and submit a purchase offer.

An offer to purchase the residence is prepared and submitted to the homeowner on an EP agreement form as mandated by state law.

However, the homeowner advises the EP investor he really wants to retain possession of the residence and **buy back** the ownership when his finances pick up.

As an alternative to the EP investor's offer, the homeowner proposes a **sale/lease-option** arrangement in which:

- the EP investor would acquire title to the property by investing only the funds needed to cure the delinquent loan payments and property taxes, and pay the annual property insurance premium;
- the seller-in-foreclosure would remain in possession under a lease with sufficient rental payments to cover the ongoing costs of ownership; and
- the seller-in-foreclosure would be given an option to repurchase the residence by repaying the EP investor with a profit.

The EP investor refuses to go along with the seller- in-foreclosure's leaseback and option proposal. The EP investor claims the seller's sale/lease-option proposal would:

- transform the EP investor's intended purchase into a loan transaction; and
- deprive the EP investor of the investment and tax benefits of owning real estate.

The EP investor and seller-in-foreclosure reach a compromise, and enter into an EP agreement which provides the seller with a six-month holdover tenancy — no repurchase option included.

Has the EP investor correctly represented the legal and tax consequences of a repurchase option on a sale-leaseback as a mortgage-in-fact?

Yes! The sale-leaseback and option arrangement constitutes a *mortgage*, not a purchase of the property by the EP investor. When a seller-in-foreclosure on his owner- occupied, one-to-four unit residential property retains possession and deeds out the title in exchange for an **option to repurchase** the property at a fixed price, a loan has been negotiated.

Here, the financial arrangement of the lease-option contains a yield (interest and principal paid as rent) and a due date (final/balloon payment of principal on exercise of option) as a condition for returning (re-conveying) title. Thus, the EP investor becomes a lender holding title as security, not a buyer receiving the possessory rights and economic risks and benefits of an owner. [CC §1695.12]

As a lender, the EP investor is not able to take depreciation or other **tax benefits** available to an owner of rental property. [**Haggard** v. **Commissioner** (9th Cir. 1956) 241 F2d 288]

Equity lending during foreclosure

Consider a seller-in-foreclosure who asks a friend to buy his residence.

The friend advances all funds necessary to cure the default under the trust deed and take the property out of foreclosure, called *reinstatement*.

As security for repayment of the friend's advance of funds, the seller-in-foreclosure conveys title to the friend. However, the seller remains in possession under a lease and option to repurchase the residence from the friend.

Later, the seller defaults on the rent due under the lease. The friend evicts the seller and sells the property to a buyer at a profit.

The seller-in-foreclosure now seeks to recover the value of his lost equity from his (former) friend. The seller claims equity purchase (EP) law requires the seller's consent to sell the property since the transaction was a loan structured as a repurchase option.

The friend claims EP law does not apply to him since he is not in the business of buying homes in foreclosure.

However, EP law applies to all persons whose conduct constitutes that of an EP investor, regardless of the number of EP transactions the EP investor completes. The friend resold the property without further written consent from the seller (even though the friend held title), in violation of equity purchase law.

The EP investor's failure to obtain the seller- in- foreclosure's written permission prior to resale of the property imposes liability on the EP investor for money damages for breach of the seller's repurchase (redemption) rights. The money damages collectible by the seller are based on the value of the property on the date the property is transferred without the seller's consent. [Segura, *supra*]

Continued occupancy

Any leaseback agreement negotiated with the seller-in-foreclosure must be reduced to a written addendum as part of the equity purchase (EP) agreement, or by amendment prior to funding by the EP investor or conveyance of title by the seller. [CC §1695.3(f)]

The seller-in-foreclosure and EP investor might agree to any one of several occupancy arrangements:

- a sale-leaseback, typically a *holdover tenancy* for a fixed time period at which point the seller-in-foreclosure must vacate [See **first tuesday** Form 272];

- a sale-leaseback with an option to purchase as an addendum (which is a mortgage-in-fact) [See **first tuesday** Forms 161 and 550]; or
- an unexecuted purchase agreement coupled with a lease-option agreement with the seller-in-foreclosure, a formal variation on the prior arrangement. [See **first tuesday** Form 163]

In a straight sale-leaseback, a security deposit and the first month's rent are payable to the EP investor since the seller-in-foreclosure will holdover for a specified time period. The seller usually pays prepaid rent and a security deposit through escrow from his net sales proceeds.

Sale-leaseback recharacterized

Inherent in an equity purchase (EP) sale-leaseback and option is the risk the loan transaction will be misinterpreted by the local assessor, the existing lender, or the Internal Revenue Service (IRS).

Reassessment of the property occurs on execution of a sale-leaseback. [**Pacific Southwest Realty Company** v. **County of Los Angeles** (1991) 1 C4th 155]

However, a sale-leaseback intertwined with an option to repurchase is correctly recharacterized by all agencies (and the seller) as a single **financing arrangement**, rather than two consecutive sales transactions. Thus, no **change of ownership** occurs, even though title is revested, and no reassessment takes place — but only if the financing scheme is brought to the attention of the assessor. [Calif. Revenue & Taxation Code §62(c)]

Title insurers usually will not issue **title insurance** to an investor taking title in an EP transaction unless the seller-in-foreclosure signs an *estoppel affidavit* declaring the EP transaction is an absolute conveyance to the EP investor and not merely security for a loan.

Thus, if the seller-in-foreclosure is given a repurchase option, the sale-leaseback is viewed as a financing arrangement. The EP investor will not be able to obtain title insurance, even though he appears as the vested owner of the property — if the title company is aware of the repurchase option. The transaction to be insurable must be restructured as a note and trust deed.

Existing lenders view a sale-leaseback, with or without a repurchase option, as an opportunity to **call or recast** a loan under their *due-on clause* — should they become aware of the facts. The two-step transaction (two sales) is in law a single mortgage transaction. Thus, the transaction is a loan. If the "loan" is on a one-to-four unit residential property which is owner-occupied, the first trust deed lender with a due-on provision cannot call the loan.

However, an EP investor should consider including a contingency in the EP agreement calling for a *due-on waiver* to be negotiated with the existing lender prior to closing.

An existing lender usually will not demand a modification or call its loan unless the current market rates are so high as to allow the lender to increase its portfolio yield through points or an increased interest rate, either by loan modification or a payoff and reinvestment in a new loan.

Federal tax consequences

The Internal Revenue Service (IRS) also treats sale- leasebacks as loan transactions, not sales or purchases, when the seller-in-foreclosure is given an option to repurchase at a fixed price. Taxwise, the sale-leaseback is a **financing arrangement** when:

- rental payments under a long-term lease equal an amortization of the fair market value over the term of the lease when title is to be reconveyed to the seller/tenant; or
- the final/balloon payment required to exercise a repurchase option equals principal and accrued interest that would be financially similar to the due-date payoff under a note and trust deed. [**M & W Gear Co**. v. **Commissioner** (7th Cir. 1971) 446 F2d 841]

The equity purchase (EP) investor's tax consequences on **recharacterization** of a sale-leaseback and purchase option as a financing arrangement include:

- denial of any depreciation deductions;
- imputing of interest income reportable at 110% of the applicable federal rate (AFR) [Internal Revenue Code §1274(e)];
- reporting of would-be rental income as investment/portfolio category interest income on a loan; and
- denial of any rental operating expenses (impound for taxes and insurance premiums belonging to the seller), since the transaction is a loan.

For the EP investor to receive the tax benefits of owning real estate, he must limit the leaseback to a periodic tenancy (month-to-month) or a tenancy with a fixed date for the tenant to vacate the premises — no repurchase option allowed.

No repurchase options

An equity purchase (EP) investor structuring a sale- leaseback, which does not include a repurchase option, eliminates the risk the transaction will be recharacterized as a financing arrangement if:

- the seller-in-foreclosure is given the lease in full or part exchange for his equity (or for his payment of rent);
- the rent charged is the current fair market rate; and
- the leaseback agreement sets a "fixed" time period for the lease to terminate and possession to be transferred to the EP investor. [**Camp** v. **Matich** (1948) 87 CA2d 660]

If the seller-in-foreclosure is not given a repurchase option and remains in possession of the property after the lease expires, the EP investor can begin an *unlawful detainer* (UD) action without prior notice to the seller to vacate, and proceed to have the prior owner evicted. [**Ryland** v. **Appelbaum** (1924) 70 CA 268]

As in any lease, the leaseback agreement should provide for payment of increased rent if the seller-in-foreclosure does not vacate on expiration of the lease or a notice to vacate under a month-to-month rental agreement. A reminder: The seller-in-foreclosure has defaulted on home payments and thus is a serious credit risk as a tenant for the EP investor.

Chapter 35 Special provisions for a promisory note

This chapter presents provisions which may be included in a promisory note, in addtion to basic provisions in standard forms.

Beyond fundamental debt obligations

A *promissory note* contains a buyer's **promise to pay** a private lender or carryback seller the principal amount agreed to, plus any interest. The note is **evidence** the debt exists.

The schedule and conditions for payment of the principal and interest are also contained in the note.

In contrast, provisions in a *trust deed*, besides referencing the note and describing the real estate liened to secure the debt, primarily address the **maintenance and preservation** of the noteholder's *security interest* in the real estate.

Special provisions added to a note serve to:

- **protect** the noteholder against risk of loss due to late payments, early payoff or other defaults on the note; and
- **comply** with statutorily mandated provisions for controlled transactions.

Special provisions to be considered for inclusion in a **promissory note** include:

- a prepayment penalty;
- due date extension;
- compounding on default;
- balloon payment notice;
- grace period and late charges;
- option for payoff discount;
- right of first refusal on sale on the note;
- reference to a guarantor;
- exculpatory clause; and
- governing law.

Prepayment penalties

A prepayment penalty is an extra charge incurred to pay off principal on a note before the principal is due by the terms of the note.

A prepayment penalty is enforceable if it is reasonably related to money losses suffered by a private lender or carryback seller, such as the payment of profit taxes incurred by a carryback seller on a premature reduction in principal or final payoff. [**Williams** v. **Fassler** (1980) 110 CA3d 7]

The amount of the prepayment penalty the private lender or carryback seller can charge depends on:

- the **type** of property; and
- the owner's **use** of the property.

Figure 1

Prepayment penalty note provisions

1. *For owner-occupied, one-to-four residential units:*

   If Payor voluntarily or involuntarily pays in any 12-month period within five years after origination an amount in excess of 20% of the original principal amount of the Note before it is due, a prepayment penalty is due in the amount of six months' advance interest on the amount prepaid in excess of 20% of the original principal balance amount, except as prohibited by law on the use of any due-on clause.

2. *For broker-arranged loan, owner-occupied, single-family residence:*

   If Payor voluntarily or involuntarily pays in any 12-month period within seven years after origination an amount in excess of 20% of the remaining principal amount of the Note before it is due, a prepayment penalty is due in the amount of six months' advance interest on the amount prepaid in excess of 20% of the remaining principal balance, except as prohibited by law on use of any due-on clause.

3. *On all other residential and nonresidential property:*

   By initialling this provision, Payor agrees if all or part of the principal is paid, voluntarily or involuntarily, before it is due, a prepayment penalty is due in the amount of ____% of the principal prepaid in excess of regularly scheduled payments.

   Payor's initials: _____________

A prepayment penalty on a note secured by an owner-occupied, one-to-four unit residential property, when more than 20% of the original amount of the note is prepaid in any 12-month period, is limited to no more than six months' advance interest on the principal reduction in excess of 20% of the original balance. [See Figure 1 §1 accompanying this chapter]

The prepayment penalty on a note secured by an owner-occupied, one-to-four unit residential property may only be charged in the first five years of the note. **After five years**, the note can be prepaid without a penalty. [Calif. Civil Code §2954.9(b)]

On a broker-arranged loan originated by a private lender and secured by an owner-occupied, single family residence (SFR), up to 20% of the remaining principal balance may be prepaid in any 12-month period without penalty.

The penalty on broker-arranged loans for any prepaid principal exceeding 20% of the remaining balance is limited to six months' advance interest on the excess principal reduction. The penalty may be imposed for up to **seven years** after origination of the loan. [Calif. Business and Professions §10242.6; see Figure 1 §2]

On notes secured by other than owner-occupied, one-to-four residential units, the noteholder may charge a reasonable penalty limited in amount and time only be reasonableness.

However, if the noteholder intends to collect a prepayment penalty should he ever call the note under a due-on clause in his trust deed (excluding one-to-four unit residential property), the borrower must

Figure 2

Late charge provisions:

1. *For owner-occupied, single-family residence:*

   Any installment on this Note not received within 10 days after the due date is delinquent and will incur a late charge on demand in the sum of 6% of the delinquent principal and interest installment amount.

2. *For broker-arranged loan:*

   Any installment on this Note not received within 10 days of the due date is delinquent and will incur a late charge on demand in the sum of 10% of the delinquent principal and interest installment amount.

3. *For broker-arranged loan, balloon payment late charge:*

   If the balloon payment due on this Note is not received within 10 days after the due date, the balloon payment will be delinquent and incur a late charge on the delinquency and thereafter on demand for each month the balloon payment remains unpaid. The late charge will be the sum of 10% of the largest scheduled monthly installment on the Note.

4. *On other than owner-occupied, single-family residence or broker-arranged loan:*

   If any installment on this Note is not received ☐ when due, or ☐ within _________ days of the due date, the installment will be delinquent and will incur a late charge on demand in the sum of ☐ $______________; or ☐ _____% of the delinquent principal and interest installment amount.

5. *For balloon payment late charge on other than owner-occupied, single-family residences or broker-arranged loans:*

   If the final balloon payment is not paid by the due date, the remaining principal balance will thereafter accrue interest at the rate of _____%.

separately sign or initial any prepayment penalty provision which includes a waiver of his right to prepay without a penalty. [CC §2954.10; see Figure 1 §3]

Late charges and grace periods

A late charge provision in a trust deed note usually imposes an additional one-time fee or interest accrual on the amount of the delinquent payment.

On notes secured by real estate, except a note secured by an owner-occupied single family residence (SFR) or a loan made or arranged by a broker, the **late charge** for the delinquent payment of an installment must be an amount **reasonably related** to:

- the private lender's or carryback seller's actual out-of-pocket losses incurred in preforeclosure collection efforts; or
- the value of the lost use of the delinquent funds. [CC §1671; see Figure 2 §4]

A typical late charge provision takes the form of a flat fee or a percentage of the monthly installment or note balance.

However, a late charge provision in a note specifying an increased interest rate on the **entire remaining principal** on default of any monthly installment, called a *default interest rate*, is unenforceable as a disguised penalty provision.

A penalty provision is **void** if it fails to reasonably estimate compensation for the lender's losses caused by the default. The rate of interest on a default can only be applied to the delinquent payment since only an installment is delinquent, not the entire principal balance of the note. [**Garrett** v. **Coast and Southern Federal Savings and Loan Association** (1973) 9 C3d 731]

The amount of a late charge on any note secured by an owner-occupied SFR is limited to the greater of:

- 6% of the delinquent principal and interest installment; or
- $5. [CC §2954.4; See Figure 2 §1]

For loans made or arranged by a real estate broker and secured by any type of real estate, a late charge is limited to the greater of:

- 10% of the delinquent principal and interest payment; or
- $5. [Bus & P C §10242.5(a); see Figure 2 §2]

Also, if the broker-arranged loan contains a due date for a **balloon payment**, a late charge may be assessed if the balloon payment is not received within ten days after the due date.

The maximum enforceable late charge for a delinquent balloon payment on a broker-arranged loan, and for each following month the balloon payment remains unpaid, is an amount equal to the maximum late charge imposed on the **largest installment payment scheduled** in the note. [Bus & P C §10242.5(c); see Figure 2 §3]

On all installment sales, except on an owner-occupied SFR, an **increased interest rate** on the remaining principal, triggered by a delinquency of the final/balloon payment, is an acceptable late charge provision. [**Southwest Concrete Products** v. **Gosh Construction Corporation** (1990) 51 C3d 701; see Figure 2 §5]

However, as a late charge, any increased interest rate triggered by a delinquency is still controlled by reasonableness. [Garrett, *supra*]

For carryback SFR notes and broker-arranged loans, an installment is not late if paid within ten days after the installment is due, called a *statutory grace period*. [CC §2954.4; Bus & P C §10242.5]

Also, on an SFR note or broker-arranged loan, the private lender or carryback seller cannot charge more than one late charge per delinquent monthly installment payment — no matter how long the payment remains delinquent. [CC §2954.4(a); Bus & P C §10242.5(b)]

Compounding on default

A *compounding-on-default interest provision* is triggered by a delinquency in a payment. Compounding causes interest to accrue on the interest contained in the delinquent installment at the note rate until the delinquent payment and compounded interest are paid. [See Figure 3]

Figure 3

Compounding interest on default provision:

On default in the payment of a principal and interest installment when due, the unpaid interest will be added to the remaining principal balance and accrue interest at the same rate as the principal debt until the delinquent payment and the accrued interest on the delinquent interest are paid.

Compounding interest provisions are used in lieu of flat fee or percentage late charge provisions.

Under a compounding interest provision, the reinstatement amount includes the delinquent principal and interest payment plus the additional compounded interest.

A compounding interest provision is a type of **late charge** since it penalizes the borrower and is triggered by a delinquency in a payment, although no case or statute defines it as such.

As a late charge, the limitations on amounts and grace periods for late charges apply to the enforcement of provisions calling for compounding on default.

Balloon payment notice

A balloon payment is a final lump sum payment of remaining unpaid principal, which is due on an earlier date than had the periodic payment schedule continued until the principal was fully amortized.

A **balloon payment note** secured by owner-occupied, one-to-four unit residential property is a note which contains provisions for:

- a *final payment* which is more than twice the amount of any of the six regularly scheduled payments preceding the date of the balloon payment; or
- a *call provision*. [CC §§2924i(d); 2957(b), (c)]

A **call provision** gives the private lender or carryback seller the right to demand final payment at any time after a specified period.

Figure 4

Balloon payment notice provision:

This Note is subject to Section 2966 of the Civil Code, which provides that the holder of this note shall give written notice to the trustor, or his successor in interest, of prescribed information at least 90 and not more than 150 days before any balloon payment is due.

Figure 5

Due date extension provision:

The due date will be extended for _______ year(s) if all monthly installments have been received prior to their delinquency.

Figure 6

Discount for early payoff provision:

Payor is hereby granted the irrevocable right to purchase or pay off and fully satisfy the Note on payment of the sum of a ______% discount in the principal remaining unpaid less a _____% discount, plus accrued interest and future advances, for the period expiring ___________________________.

All balloon payment notes secured by one-to-four unit residential property must include a reference to the buyer's right to receive a *balloon payment notice* 90 to 150 days before the due date. [CC §§2924i; 2966; See Figure 4]

Failure to include the balloon payment notice provision in the note will not invalidate the note, but enforcement of the note's balloon payment provision is still subject to the notice requirements. [CC §2966(d)]

Extension of due date

A provision may grant the buyer an extension of the due date for a final/balloon payment conditioned, for example, on the payment of all scheduled installments without delinquency, or on other consideration, such as a charge or change of terms. [See Figure 5]

An agreement to extend the due date in a carryback note should be considered by a buyer when the term of the note is for a short period of time and the buyer is uncertain about the source and availability of funds for payoff.

Discount for early payoff

A buyer's right to pay off the note early is usually documented in the form of an option to buy the note at a discount. [See Figure 6]

A carryback seller who prefers to be cashed out before the due date on his trust deed note could include a discount provision to encourage the buyer to pay off the note within a lesser time period than the due date period. The provision can be structured to give the buyer several months to exercise the option to pay off the debt at a discount on the face value (or remaining balance) of the note.

By exercising the option, the buyer who executed the note is buying the note and trust deed from the seller by an assignment.

Figure 7

Right of first refusal provision:

Payee hereby grants Payor a right of first refusal to purchase the Note and Trust Deed.

Should Payee decide to sell an interest in the Note and Trust Deed, Payee shall notify Payor of the terms on which Payee is willing to sell or assign.

Payor shall have the option for a period of _____ days after receiving notice to purchase the Note and Trust Deed on the terms stated in the notice.

Should Payor fail to exercise the option within the option period, Payee will have the right to sell the Note and Trust Deed to a third party on the same terms stated in the notice to Payor. Any sale on different terms reinstates the right of first refusal.

If the Note is not sold within six (6) months after Payor's receipt of notice, the right of first refusal is reinstated.

Figure 8

Guarantee provision:

The Note is guaranteed by ______________________________, under a Guarantee Agreement dated____________________, at ______________________________, California. [See Form 439]

Figure 9

Exculpatory provision:

This Note and Deed of Trust is subject to the purchase money anti-deficiency provisions of California Code of Civil Procedure 580b.

Figure 10

Governing law provision:

This Note will be governed by California law.

Right of first refusal

When the noteholder decides to sell the note, a *right of first refusal* provision contained in the note or a separate agreement allows the buyer of the secured real estate to purchase or pay off the note. [See Figure 7]

If the noteholder decides to sell the trust deed note, the buyer is notified of the amount necessary for payoff.

The **payoff amount** will be the sales price of the note and is set based on either:

- the noteholder's listing of the trust deed note for sale, or their offer to sell the note; or
- an offer from an investor to purchase the note, which, if accepted, must be accepted contingent on the buyer's exercise of the right to pay off the note.

The buyer, to exercise the right of first refusal, must then match the price.

However, when granting the right of first refusal, the noteholder must be careful not to set the price in advance by stating a price in the right of first refusal provision.

If the payoff amount is set by a prior agreement, the seller is bound by the amount, even if market conditions allow for a higher value when the seller decides to sell the note.

Guarantor

To protect the private lender or carryback seller from loss due to a default on his trust deed note, the private lender or seller may require a third party with sufficient assets to become *liable on call* for all amounts due under the note and trust deed. By guaranteeing the note, a guarantor literally agrees to buy the note from the private lender or carryback seller, called *subrogation* or *equitable assignment*.

The private lender or carryback seller has three types of third party assurances:

- a co-owner's signature on the note and trust deed;
- a co-signer's signature on the note only; or
- a personal guarantee of the note by one other than the buyer.

When a third part signs the note, the third party becomes **liable for repayment** of the note, subject to anti-deficiency rules protecting co-owners on any type of foreclosures and co-signers on trustee's foreclosures. [California Code of Civil Procedure §580b]

However, if a third party agrees to **guarantee** the note and trust deed, a guarantee agreement is signed by the third party and is **enforceable separately** from the note and trust deed. [See **first tuesday** Form 439]

If the note is guaranteed, a provision may be included in the note to reference the separate guarantee agreement. [See Figure 8]

By referencing the separate guarantee agreement in the note, everyone is on notice of the additional security for the note provided by the guarantee.

Exculpatory clause

An *exculpatory clause* in a note converts a lender's recourse paper into nonrecourse paper. Conversely, recourse paper is created when the note carried back by a seller is either separately or additionally secured by property other than the property sold. [See Figure 9]

When an exculpatory clause is included in a cross-collateralized note (two or more properties are described as the security), the private lender and the carryback seller cannot obtain a money judgment for any deficiency on a judicial foreclosure of the secured property. Thus, the note has agreed-to anti-deficiency protection.

Governing law

A private lender or carryback seller involved in negotiating a carryback sale with an out-of-state buyer must include a "choice-of-law" provision to assure judgments arising from disputes on the note will be based on California law. [See Figure 10]

Chapter 36 Due-on-sale regulations

This chapter explains which events trigger a lender's due-on clause and discusses the adverse effects of due-on regulations on the real estate market.

Rising rates bring lender interference

A parcel of real estate which is listed for sale is security for a loan under a first trust deed lien containing a *due-on clause*. The listing agent locates a buyer for the property.

The purchase agreement negotiated by the listing agent calls for closing to be contingent on the buyer entering into an assumption agreement with the first trust deed lender. The seller will carry back a note secured by a second trust deed for the balance of the purchase price after the buyer's down payment.

The buyer is advised the senior lender may:

- refuse to allow the loan to be assumed, forcing the buyer to obtain new financing to acquire the property; or
- require a modification of the loan at a less favorable rate than the note rate on the loan and demand a large assumption fee.

Before contacting the lender to process an assumption, the buyer suggests the sale of the property be structured as a lease-option in an attempt to avoid due-on enforcement by the lender.

The buyer and seller discuss entering into a two-year lease agreement with an option to extend the lease for two years at an increased monthly payment. The buyer will be granted an option to purchase for the life of the lease.

The down payment will be restated as *option money*. The option money will apply to the purchase price of the property, as will a portion of each monthly payment, called *rent*.

Meanwhile, the seller will continue making payments on the trust deed loan. When the buyer exercises his purchase option, the loan will be assumed or paid off and the buyer will become the record owner of the property.

Does the lease-option sale avoid due-on enforcement by the lender?

No! Any lease agreement which contains an option to purchase triggers due-on enforcement by the lender on discovery. [12 Code of Federal Regulations §591.2(b)]

Lender interference authorized by federal mortgage law

Generally, the federal *Garn-St. Germain Depository Institutions Act of 1982 (Garn)* allows all lenders and carryback sellers to enforce their due-on sale clauses in trust deeds on nearly all transfers of an interest in any type of real estate. Thus, the *Garn Act* deprived Californians (and residents of numerous other states) of their state law right to take title to real estate subject to trust deed liens without lender due-on interference, unless the lender could show the buyer lacked creditworthiness. [12 United States Code §1701j-3] Thus, each event triggering due-on enforcement automatically allows the lender to:

- **call the loan**, demanding the full amount remaining due be paid immediately, also known as *acceleration*; or
- **recast the loan**, requiring a modification of the loan's terms as a condition for the lender's consent to a transfer, called a *waiver*.

The *Garn Act* encourages lenders to allow buyers to assume real estate loans at existing rates, but provides lenders no incentives for doing so. The congressional intent in passing the *Garn Act* was to pre-empt state law restrictions of due-on enforcement for profit. However, the enforcement of the due- on-clause by lenders was not intended to occur at the expense of permitting excessive lender interference with real estate transactions, whether they are sales, leases or further encumbrances. [12 USC §1701j-3(b)(3)]

Yet, when the Federal Home Loan Bank Board (now the Office of Thrift Supervision (OTS)) issued regulations to implement *Garn*, no notice was taken of the congressional request for leniency when exercising due-on rights.

The OTS regulations allow automatic due-on enforcement on any transfer of an interest in real estate, with only a few exceptions. No encouragement or guidelines were established for lenders to consent to loan assumptions or to limit interference in commonplace transactions.

Since lenders often disregard the law in their trust deed lending and enforcement practices, it is hard to imagine why they would comply with a congressional request. In the absence of any regulatory obligation, lenders use their due-on clauses to maximize their financial advantage by calling or recasting loans on the sale of the secured property. Thus, they increase their portfolio yield in a rising interest rate market.

Economic recessions and recoveries

In times of stable or falling interest rates, lenders, when requested, usually permit assumptions of loans at the existing note rate, unless a prepayment penalty clause exists. Lenders have no financial incentive to recast the loans or call and re-lend the funds at a lower rate.

However, in times of steadily rising rates, lenders seize any event triggering the due-on clause as an opportunity to increase their interest yield. Once the due-on clause is triggered, the lender requires the loan be recast at current market rates as a condition for allowing an assumption, lease or further encumbrance of the property.

Thus, real estate ownership encumbered by due-on trust deeds become increasingly difficult to transfer as interest rates rise. Lender due-on interference is virtually guaranteed since the interference results in an increase in the lender's portfolio yield which permits them to remain solvent.

However, the inhibiting effect on buyers during recessions when buyers are required to assume existing financing at higher interest rates has an adverse economic effect on real estate sales, as well as the availability of private junior financing and long-term leasing. Ultimately, as rates and lender interference rise, many buyers, equity lenders and tenants are driven out of the market, which further depresses property values.

Meanwhile, owners are faced with the prospect of watching the value of their property fall below the remaining balance on encumbrances, leaving owners with no equity in the property. It is a vicious cycle which ends in a dramatic increase in loan foreclosures.

Due-on interference was an obscure issue during the 12-year period (1982 through 1994) after *Garn* became law. During this period, mortgage rates declined from 15% to 7%, buyers earned more money and mortgage money became more plentiful.

Due-on-sale

Due-on clauses are most commonly known as *due-on-sale* clauses. However, "due-on clause" is a more accurate term since a sale is not the only event triggering the clause. Still, as the name "due-on-sale" suggests, the primary event triggering the lender's due-on clause is a sale of property which is subject to the lender's trust deed lien.

The due-on clause is triggered not only by a transfer using and recording a standard grant deed or quitclaim deed, but by any conveyance of legal or equitable ownership of real estate, whether or not recorded. Examples include a land sales contract, lease-option sale, or other alternative carryback device, such as an all-inclusive trust deed (AITD).

For example, a land sales contract does not involve a conveyance of real estate to the buyer by grant deed, since the seller retains the title as security for the carryback debt owed by the buyer. However, the buyer becomes the *equitable owner* of the property as soon as the land sales contract is entered into and possession is transferred, triggering the due-on clause in any existing trust deed. [**Tucker** v. **Lassen Savings and Loan Association** (1974) 12 C3d 629]

Due-on-lease

The due-on clause is also triggered by:

- a lease with a term over three years; or
- a lease for any term with an option to purchase. [12 CFR §591.2(b)]

For example, an owner with a short-term interim construction loan for nonresidential rental property obtains a conditional commitment from a long-term lender for take-out financing to pay off the construction loan. Funding of the take-out loan is conditioned on the property being 80% occupied by tenants with initial lease terms of at least five years.

The owner locates tenants for 80% of the newly constructed property, all with lease terms of five years or more. The lender funds the loan. The loan is secured by a first trust deed on the property which contains a due-on clause. The existing five-year leases do not trigger the due-on clause in the lender's trust deed. The long-term leases have priority since they were entered into before the loan was funded and the trust deed was recorded.

However, after obtaining the loan, the owner continues to lease out space in his property for five year terms. Later, after interest rates rise, a representative of the lender visits the property and "discovers" new tenants. On inquiry, the officer learns that some of the tenants who entered into leases after the loan was recorded had their leases extended for more than three years.

The lender sends the owner a letter informing him it is calling the loan due since the owner has entered into lease agreements with terms over three years.

The owner claims the lender cannot call the loan since long-term leases were required by the lender as a condition for funding the loan.

Can the lender call the loan due or demand a recast of its terms?

Yes! By requiring leases with terms over three years as a condition for funding the loan, the lender did not waive its right to call or recast the loan under its due-on clause based on a lease with a term over three years entered into after the loan was originated.

However, an **assignment** or **modification** of an existing lease does not trigger the due-on clause, unless the lease is modified to extend the term beyond three years, or a purchase option is added.

For example, consider an owner of real estate who enters into a lease with an initial term of 10 years. Later, the owner takes out a loan secured by a trust deed containing a due-on clause. After the trust deed is recorded, the tenant assigns the lease with the owner's approval, as provided in the lease agreement (which has priority).

Due-on enforcement and prepayment penalties

Consider an owner of real estate which is encumbered by a trust deed securing a note containing a **prepayment penalty clause**. The owner sells the property, triggering the due-on clause in the lender's trust deed.

The lender, unwilling to consent to an assumption by the buyer, calls the loan due. The buyer obtains a new purchase-assist loan from a different lender, enabling the buyer to pay off the existing loan.

The lender informs the buyer he will have to pay a prepayment penalty due to his early payoff of the loan.

The buyer claims he cannot be charged a prepayment penalty since the early payoff was not the buyer's choice, but was a result of the lender exercising his right to call the loan due-on-sale. Thus, the note is due by its terms.

Can a lender charge a prepayment penalty after calling a loan due?

Yes! The prepayment penalty clause in most trust deeds allows the lender to charge a penalty if the loan is **voluntarily or involuntarily** paid off before the due date**.**

Before 1983, a lender's prepayment penalty clause frequently called for a penalty only if the property owner voluntarily paid off the loan before the due date. Thus, the lender was barred from enforcing prepayment penalties in an *involuntary payoff* after calling a loan due under the due-on clause. [**Tan** v. **California Federal Savings and Loan Association.** (1983) 140 CA3d 800]

The lenders' response to the *Tan* decision was to reword their prepayment penalty clauses to impose a penalty for any prepayment of the loan, whether voluntary or involuntary.

However, when a loan is secured by a trust deed on owner-occupied, one-to-four unit residential property, federal regulations bar the lender from imposing a prepayment penalty when accelerating the loan under its due-on clause. [12 CFR §591.5(b)(2)]

However, the lender's due-on clause is not triggered by the lease assignment. The trust deed is attached only to the fee, not the leasehold interest which had previously been conveyed to the tenant. The fee owner whose interest is encumbered by the loan transferred nothing. The assignment of a leasehold by a tenant is not a transfer of an interest in the fee.

However, consider a landlord who releases the original tenant from all liability under the lease as part of an assumption of the lease by the new tenant and substitution of liability. The release of the original tenant from liability creates a *novation* of the lease — a new agreement conveying an interest in the secured property to the new tenant by the owner of the fee. [**Wells Fargo Bank, N.A.** v. **Bank of America NT & SA** (1995) 32 CA4th 424]

Thus, an assumption of the lease by a new tenant, and a release of the former tenant from liability, constitutes a present transfer of an interest affecting the fee ownership of the real estate since it is a novation. Accordingly, a lease **novation** triggers the due-on clause — if the lease has a remaining term of over three years or includes an option to purchase.

Due-on-further encumbrance

An owner-occupant of a single family residence (SFR) subject to a first trust deed applies for an **equity loan** to be secured by a second trust deed on his property. The first trust deed contains a due-on clause.

The loan broker tells the owner he is concerned about due-on enforcement by the senior lender, since the execution of a second trust deed will convey a security interest in the property by encumbering it with a lien. On inquiry, the owner informs the broker he will continue to occupy the property.

The broker correctly assures the owner the second trust deed encumbrance will not trigger the senior lender's due-on clause, as long as the owner continues to occupy the residence. Due-on enforcement based on a further encumbrance of an owner-occupied, one-to-four unit residential property is not permitted. [12 CFR §591.5(b)(1)(i)]

However, on real estate other than an owner- occupied, one-to-four unit residential property, any further encumbrance without first obtaining the existing lender's waiver of its due-on clause triggers the due-on clause, giving the lender the right to call or recast the loan.

Thus, junior financing without a waiver of the senior lender's due-on clause becomes a risky enterprise for trust deed investors in times of rising interest rates. Increasing market rates give trust deed lenders a powerful incentive to call loans on the transfer of any interest in the secured real estate — with the exception of owner-occupied, one-to-four unit residential properties.

For example, a private lender accepting a junior trust deed position on other than an owner-occupied, one-to-four unit residence without first obtaining a due-on waiver from the senior lender risks having the economic value of his position in title:

- **reduced** by an increase in the interest rate on the first; or
- **wiped out** by the first's foreclosure, should the first exercise its due-on rights based on the further encumbrance. [**La Sala** v. **American Savings & Loan Association.** (1971) 5 C3d 864]

Owners are forced to look elsewhere for funds when the existing lender does not grant a due-on waiver. Owners will be forced to refinance existing encumbrances in order to generate cash from their equity in the property, typically a more expensive process than had they obtained an equity loan.

Now consider a seller who carries back a second trust deed on the sale of property without the consent of the holder of the first trust deed which contains a due-on clause.

The first trust deed lender learns of the sale and calls the loan. To avoid the call, the buyer assumes the first trust deed loan and modifies the note by shortening the due date.

The carryback seller claims his second trust deed now has priority over the first trust deed since the modification of the first trust deed note substantially impairs his security by increasing the potential for default on his trust deed.

Here, the modification of the first trust deed note without the consent of the junior carryback seller does not result in a change in trust deed priorities since the existence of the second trust deed note is in violation of the due-on clause in the first trust deed.

When the secured property is sold and the seller accepts a second trust deed without receiving the lender's prior written consent, the due-on clause has been breached under federal mortgage law. Thus, no duty is imposed on the first trust deed lender to avoid subordinating the interest of the holder of the unconsented-to junior lien by recasting the first trust deed note. [**Friery** v. **Sutter Buttes Savings Bank** (1998) 61 CA4th 869]

Due-on-foreclosure

A parcel of real estate is subject to first and second trust deed liens. An owner defaults on the first trust deed. The junior trust deed holder reinstates the first trust deed and forecloses on the second, acquiring the property at the trustee's sale.

The senior lender informs the junior lender, who now owns the property, that it is calling its loan due, based on the transfer of the property by trustee's deed.

Can the senior lender call its loan due based on the completion of foreclosure by the second trust deed lender?

Yes! A senior lender may call a loan due on completion of the foreclosure sale by a junior lender or carryback seller on any type of real estate. A *trustee's deed* on foreclosure is considered a voluntary transfer by the owner, since the power of sale authority in the junior trust deed was agreed to by the owner of the real estate.

However, the due-on clause is not only triggered by the voluntarily agreed-to trustee's sale, but also by any involuntary foreclosure, such as a tax lien sale. [**Garber** v. **Fullerton Savings and Loan Association** (1981) 122 CA3d 423]

Federal regulations allow due-on enforcement on **any transfer** of real estate which secures the lien. [12 CFR §591.2(b)]

The risk of a senior lender enforcing its due-on clause on a trustee's sale by the junior lender has an inhibitory effect on the availability of junior trust deed loans and carryback sales. Many lenders and sellers are unwilling to accept a junior position which exposes them to paying off a senior debt should they be forced to foreclose on the real estate. [**Pas** v. **Hill** (1978) 87 CA3d 521]

Due-on-death and exceptions

Transfers of real estate which trigger due-on enforcement include the inevitable transfer resulting from the death of a vested owner. However, as with due-on enforcement triggered by further encumbrances, some exceptions apply to owner-occupied, one- to-four unit residential property.

For example, the transfer of a one-to-four unit residential property to a relative on the death of the owner-occupant does not trigger the due-on clause, on the condition the relative becomes an occupant of the property. [12 CFR §591.5(b)(1)(v)(A)]

Also, where two or more people hold title to one-to-four unit residential property as joint tenants, the death of one **joint tenant** does not trigger due-on enforcement as long as at least one of the joint tenants, whether the deceased or a surviving joint tenant, occupied the property at the time the loan was originated. Occupancy is not required for a surviving joint tenant who qualifies for the joint tenancy exception. [12 CFR §591.5(b)(1)(iii)]

In all other transfers, the death of a vested owner, joint tenant or other co-owner will trigger the lender's due-on clause. Thus, due-on enforcement is **triggered on death** by:

- a transfer of the deceased's residence to a non-relative following the death of the owner;
- the death of a joint tenant owning a one-to-four unit residential property which was not originally occupied by any of the joint tenants;
- the death of a co-owner of property other than one-to-four unit residential; and
- the transfer of any property, other than the deceased's residence, to a relative or anyone else on the death of the owner.

Divorce and inter-family transfers

A married couple occupies a residence which is vested in the name of the husband and owned as his separate property. The residence is subject to a trust deed containing a due-on clause.

The couple separates and the residence is transferred to the wife as part of the property settlement to dissolve the marriage. The wife continues to occupy the residence.

Does the transfer of the residence to the wife on divorce trigger due-on enforcement by the lender?

No! Federal due-on regulations bar due-on enforcement on transfer of one-to-four unit residential property to a spouse after a divorce, so long as the spouse occupies the property. [12 CFR §591.5(b)(1)(v)(C)]

However, if the acquiring spouse chooses to lease the residential property to tenants rather than occupy it, the lender can call or recast its loan.

Also, the due-on clause is not triggered by an owner's transfer of his one-to-four unit residential property to a **spouse or child** who occupies the property. [12 CFR §591.5(b)(1)(v)(B)]

This inter-family transfer exception for four-or-less residential property applies only to transfers from an owner to a spouse or child. For instance, any transfer from a child to a parent to provide housing for the parent triggers due-on enforcement.

Finally, consider an owner-occupant of one-to-four unit residential property who transfers the property into an *inter vivos trust*, naming himself as beneficiary. The owner continues to occupy the property after transferring title into the trust, commonly known as a *living trust*.

The owner **notifies the lender** he will be transferring title into the trust vesting. The owner agrees to give the lender notice of any later transfer of his beneficial interest in the trust or change in occupancy of the property.

Would this transfer into a living trust trigger the due-on clause in a trust deed encumbering the owner's residence?

No! The owner met the regulatory conditions for avoiding due-on enforcement based on a transfer of owner-occupied, one-to-four unit residential property into an inter vivos trust. [12 CFR §591.5(b)(1)(vi)]

To meet regulations, the owner must provide means **acceptable to the lender** by which the lender will be given notice of any later transfer of the beneficial interest in the trust or change in occupancy. If the owner conveys the property into the inter vivos trust without the lender's approval of the notice provision, the lender may call the loan due.

The notification requirement requires the owner to first obtain the lender's consent before transferring the property into a trust vesting.

Also, if the owner does not continue to occupy the property, or later transfers the beneficial interest in the trust, the lender can call or recast the loan.

Waiver by negotiation and by conduct

Under federal regulations, lenders have the power to dictate the fate of most real estate transactions, since most real estate is encumbered by trust deeds containing due-on clauses.

However, an owner wishing to enter into a transaction to sell, lease or further encumber his real estate without lender interference must first negotiate a **limitation or waiver** of the lender's due-on rights.

Waiver agreements are basically trade-offs. The lender will demand some consideration in return for waiving or agreeing to a limitation of its future due-on rights, such as increased points on origination, additional security, increased interest, a shorter due date or an assumption fee.

For example, a buyer applies for a loan to purchase a residence which he intends to occupy for only a few years. The buyer is concerned due-on enforcement will later make it more difficult for him to resell the property since it will limit the seller's ability to finance the sale of his equity.

Thus, the buyer and the lender negotiate the conditions on which a later qualified buyer will be able to assume the loan without a call by the lender. In exchange for the lender's limitation of its future due-on rights, the buyer agrees to pay increased points or interest.

Any time a lender recasts a loan as a condition for consenting to a buyer's assumption, it is essentially forcing a *modification agreement* on the buyer. In exchange for agreeing not to call the loan due on a transfer of the property to the buyer, the lender receives consideration, such as increased interest and an assumption fee.

The lender's waiver of its due-on rights under an assumption agreement applies only to the present transfer to the buyer. Unless additionally agreed to, any **later transfer** of an interest in the property will trigger the due-on clause, allowing the lender to call or recast the loan again.

In addition to a waiver (assumption) agreement, waiver of the lender's due-on rights may occur **by conduct** — the lender loses its due-on rights by failing to promptly enforce them.

For example, a buyer purchases real estate subject to a loan secured by a trust deed containing a due-on clause. The lender is informed of the transfer and immediately calls the loan. However, the lender then accepts payments from the buyer for over a year. Finally, the lender seeks to enforce its prior call by refusing further payments and foreclosing.

However, the lender, **by its conduct**, waived the right to enforce its due-on clause. The lender accepted payments from the buyer for over a year after calling the loan on learning of the transfer of the real estate. [**Rubin** v. **Los Angeles Federal Savings and Loan Association** (1984) 159 CA3d 292]

Broker liability for due-on avoidance

When the seller intends to transfer ownership of the property to the buyer, the senior lender's due-on clause is triggered regardless of the form used to document the sales transaction.

Of course, the lender can only call the loan when it actually discovers a change of ownership has taken place. If the buyer's option is not recorded, and the lease agreement is for a term under three years, the lender might not discover any transfer of an interest in the real estate has taken place, which triggered its due-on clause.

If the lender later discovers a change of ownership has taken place, its only remedies against the buyer and seller are to call the loan due, or recast the loan as a condition for waiving its right to call and allowing an assumption by the buyer. Under the note and trust deed, the lender cannot recover the *retroactive interest differential* (RID) for the period before it discovered the transfer and called the loan. The only recourse against the buyer or seller is to call the loan and be paid in full or foreclose. [**Hummell** v. **Republic Federal Savings & Loan** (1982) 133 CA3d 49]

However, **an adviser**, such as a broker or attorney, assisting the buyer or seller to mask the change of ownership from the lender primarily to avoid due-on enforcement, can be held liable for wrongfully interfering with the lender's right to call or recast the loan, an offense called *tortious interference with prospective economic advantage*.

The adviser's liability arises based on the extent to which his actions were **specifically intended** to conceal the transfer and prevent a call by the lender, and on the **foreseeability** the lender would incur losses due to the concealment. [**J'Aire Corporation** v. **Gregory** (1979) 24 C3d 799]

The lender's losses caused by the adviser's wrongful interference are calculated based on the *interest differential* between the note rate and the market rate on the date of sale, retroactively applied from the date of discovery by the lender to the date of the transfer.

Chapter 37 Late charges and grace periods

This chapter examines the purpose and enforcement of late charge provisions in trust deed notes evidencing private carryback sales and lender loans.

Unrelated costs and earnings

A seller carries back a note and trust deed on the sale of any type of real estate. The note calls for the buyer to pay periodic installments on the first of each month, called the *payment due date*.

The note contains a **late charge** provision. When an installment becomes *delinquent*, it is agreed the interest rate on the entire outstanding principal balance, called the *note rate*, will increase by 2% until the delinquency is cured, called a *default rate*.

Later, the seller does not receive an installment before it becomes delinquent. The seller makes a written demand on the buyer to pay the delinquent installment, together with additional (per diem) interest on the entire principal balance between the due date and receipt of the delinquent installment.

The buyer tenders the regularly scheduled payment, but refuses to pay the demand for additional interest. The buyer claims the default rate is an invalid *liquidated damages provision* since the amount exceeds the out-of-pocket money losses the seller incurred due to the delinquency.

The seller claims the late charge is a valid, enforceable provision since the buyer agreed to the charge in the note and the actual costs of collection incurred by the seller are difficult to ascertain.

Can the seller enforce the default rate provision in the note?

No! The provision is a late charge which is unreasonable in amount and thus unenforceable. The amount of the charge for being delinquent is additional interest on the **entire debt**, not just on the principal and interest due with the delinquent payment. Thus, the delinquency charge is based on amounts owed but not yet due.

For all notes secured by any type of real estate, a late charge provision calling for an increased interest rate on the entire principal balance and triggered by the delinquency of a monthly installment is a *disguised penalty provision*.

Disguised penalty provisions are void, and thus unenforceable. To be enforceable, the carryback seller's compensation under the late charge provision must be limited to his monetary losses caused by the delinquency. [**Garrett** v. **Coast and Southern Federal Savings and Loan Association** (1973) 9 C3d 731]

Elements of a late charge

To establish the right for a carryback seller to enforce collection of a late charge, the following conditions must be met:

- a late charge **provision** exists in the note;
- a scheduled payment is **delinquent**;
- a **notice** is delivered demanding payment of the late charge;

- the amount of the late charge is within the limits set by statutes (for money lenders) or **reasonableness standards** (for carryback sellers); and
- compliance with **accounting** requirements.

Distinctions exist in the treatment of late charges between private lender loans and carryback paper. For private lenders, late charges on loans secured by single-family residences (SFRs) are treated differently from loans on other types of property. As for private lenders, the amount of the late charge is controlled by whether or not the loan was made or arranged by a broker.

Also, failure to pay a late charge is a *non-material breach*. Thus, failure to pay late charges cannot be the sole monetary basis for commencing a foreclosure.

Late charges are negotiated

Late charge provisions are included in all notes used by institutional lenders and are nonnegotiable, due primarily to uniform ceilings set by statute or demanded in the secondary mortgage money market. However, the inclusion of late charge provisions in notes carried back by sellers are negotiable.

For a late charge provision to be included in a carryback note, the charge must first be included by negotiation in the purchase agreement as a condition of the carryback note. When the provision is agreed to in the purchase agreement, it is then proper to include the late charge provision in the note prepared by escrow for the buyer's signature. [See **first tuesday** Forms 150 §8.1 and 250]

The clause and the amount

For a late charge provision to be complete, the provision must include:

- the amount of the late charge;
- the span of any grace period after the due date before a payment is delinquent; and
- a requirement for notice from the trust deed holder of the imposition of a late charge and demand for its payment.

The amount of a late charge imposed for delinquent payment on a debt secured by real estate, except private loans secured by owner- occupied SFRs, must be reasonably related to money losses incurred by the creditor (carryback seller) due to the delinquency. [Calif. Civil Code §1671]

Late charge provisions are triggered by the delinquency of a periodic payment or final/balloon payment, but the charge is not automatically due. Unless the delinquency is followed by a **notice** imposing the charge and demanding its payment, the charge is waived. [CC §1501]

The **monetary losses** collectible as a late charge based on a delinquency include:

- the actual *out-of-pocket expenses* incurred in a reasonable collection effort; and
- the *lost use* of the principal and interest (PI) portion of the delinquent payment.

Money losses incurred in a reasonable effort to collect a late payment include the cost of forms, envelopes and postage for mailing the notice, and time spent by individuals in collection efforts.

However, even if the late charge provision is void as a windfall to the carryback seller for being excessive in amount, the buyer is still liable for the lender's actual money losses resulting from the delinquency. [Garrett, *supra*]

When a scheduled payment is not timely received, a late charge provision in an installment note imposes either:

- an additional one-time fee; or
- the accrual of interest on the delinquent PI amount.

For example, a one-time late charge takes the form of a **flat fee**, such as $50.00, or a **percentage** of the monthly PI installment, such as 5%. Infrequently, the late charge is disguised as an unenforceable increased interest rate on the entire principal, as presented in this chapter's opening facts.

Initially, any formula or percentage used to determine the amount of a one-time late charge is suspect. Based on the premise a lender is only entitled to reimbursement for the lender's collection efforts, unjust enrichment arises in larger loans when a formula or percentage is used since the same amount of time, effort and funds are expended in collection on a $50,000 loan as are expended on a $500,000 loan. [Garrett, *supra*]

Late charge notice

To collect a late charge under a note secured by **any type of real estate**, the holder of the note must notify the owner of the charge and **make a demand** for its payment.

Private lenders must make a demand for the late charge by either:

- a written statement of the late charge concurrent or within 10 days after mailing a notice to cure a delinquency; or
- a billing statement or notice sent for each payment as they become due on the loan stating the late charge and the date it will be incurred. [CC §2954.5(a)]

Regarding **carryback notes**, if, on receipt of a delinquent payment, the carryback seller fails to make a demand for payment of the late charge, he *waives* his right to collect a late charge on the installment. [Calif. Code of Civil Procedure §2076; CC §1501]

After continually receiving delinquent payments and failing to impose late charges, the carryback seller must first give the buyer advance notice of his intention to thereafter demand a late charge on future installments should they become delinquent. Lack of notice regarding future enforcement after a period of non-enforcement constitutes a *waiver*. Thus, the right to enforce the grace period and late charge on future delinquencies must first be reinstated. [**In re Hein** (9th Cir. 1986) 60 BR 769; CC §2954.5(b),(e)]

What if the payment was mailed (post-marked) within the grace period but received by the lender after the grace period expired?

Mailing the installment within the grace period does not qualify the payment as timely paid. The payment must be **actually received** by the carryback seller, lender or collection agent no later than the last day of the grace period, and be immediately negotiable. [**Cornwell** v. **Bank of America National Trust and Savings Association** (1990) 224 CA3d 995]

Conversely, if the note requires the owner to make the payment by employing a particular method of payment, such as by mail, the payment is considered received when the owner places the payment in the mail as agreed, even if the noteholder never receives the payment. [CC §1476]

Balloon payments

Excluding owner-occupied SFRs and broker-arranged loans, a private lender or carryback seller may enforce a default rate provision which calls for an increase in the interest rate on the remaining principal when the **final/balloon payment** on a loan or an installment sale becomes delinquent. [**Southwest Concrete Products** v. **Gosh Construction Corporation** (1990) 51 C3d 701]

However, the default rate charge must be reasonable and triggered only by the expiration of any grace period on the final payment. [Garrett, *supra*]

Impound accounts

An impound account is a money reserve consisting of the property owner's funds. From the impounded funds the carryback seller pays the impounded periodic obligations the owner owes on the property, such as:

- property taxes;
- insurance premiums;
- assessments for common area or easement maintenance;
- water stock; or
- bonded offsite improvements.

To fund the impound account, a pro rata amount of the anticipated property taxes and insurance premiums (TI) are collected each month along with the monthly PI payments (PITI).

For late charge purposes, the tax and insurance portion — impounds — of the owner's monthly PITI payment must not be included in the formula for computing the amount of the late charge. The TI funds are the owner's money, accumulated by the carryback seller to pay obligations of the owner to others.

Enforcement of the late charge

Refusal or failure of an owner to meet a demand to pay a late charge agreed to in a trust deed note is a *non-material breach* of the note and trust deed. Thus, non-payment of a late charge alone will not justify a call of the loan and commencement of foreclosure. [**Baypoint Mortgage** v. **Crest Premium Real Estate Investments Retirement Trust** (1985) 168 CA3d 818]

Thus, a carryback seller is not entitled to foreclose on an owner who has tendered all installments which are due, but has not paid outstanding late charges.

Collection of late charges must be enforced by means other than foreclosure when no other monetary breach exists. Also, a private lender making a loan on any type of real estate is required to furnish the owner with a **semiannual accounting** for the total amount of late charges due during the accounting period. [CC §2954.5(b)]

Further, for late charges on a carryback note secured by property improved with only a one-to-four family residence, the carryback seller must provide the owner with an **annual accounting** statement detailing any late charges received during the year. [CC §2954.2(a)]

Also, a court action to collect the late charge is not advisable. An action would violate the one-action rule and cause a forfeiture of the trust deed lien since the late charge is a debt secured by the trust deed. [CCP §726(a)]

Thus, collection of accumulated unpaid late charges seems limited to a demand for reinstatement to rescind a foreclosure (started due to a material breach) or on final payoff.

Late charges and public policy

Carryback sellers tend to assume they can charge late fees of any amount since statutory limitations of 6% of the PI payment only apply to loans secured by owner-occupied SFRs and loans made or arranged by a real estate broker, a conclusion sometimes called a *negative presumption* — which is usually erroneous.

To the contrary, legislative limitations imposed on SFR loans tend to establish public policy for amounts which are deemed reasonable. Further, case law has set standards requiring late charges to bear a *reasonable relationship* to the cost of the lender's collection efforts and loss of use of the delinquent payment. [Garrett, *supra*]

Chapter 38 Converting nonrecourse paper into recourse paper

This chapter explains how a nonrecourse note held by a lender or carryback seller becomes recourse paper through later agreements with owners.

Substituting or eliminating the security

A seller holds a carryback note secured by a third trust deed on real estate he sold, called a *purchase money* note.

The buyer defaults. On investigating the financial feasibility of foreclosing and repossessing the property, the seller decides to forego foreclosure.

The buyer wants to retain the property, but needs the seller to subordinate his trust deed to a new loan which will refinance the first and second trust deeds.

The seller offers to reconvey the carryback trust deed in exchange for the buyer executing a new note for the debt owed, secured by a junior trust deed on real estate other than the property sold. The buyer provides security which the seller accepts, called *substitute security*.

By mutual agreement between the buyer and the seller:

- the seller cancels the purchase money note and reconveys the carryback trust deed; and
- the buyer signs and delivers a new note and trust deed in favor of the seller, secured by other real estate owned by the buyer.

Thus, the buyer **substituted security** for the debt owed to the seller. But remember, the new note merely evidences the same carryback credit sale debt as evidenced by the cancelled note.

Later, the holder of the first trust deed on the substituted security forecloses, wiping out the seller's trust deed lien.

Since the carryback seller's substituted security interest has been eliminated, called *exhaustion of the security*, he sues the buyer to obtain a money judgment for the amount unpaid on the note.

The buyer claims the seller is barred by anti-deficiency rules from collecting on the note. The note evidences a purchase money debt created between the buyer and the seller to finance the sale of real estate. [Calif. Code of Civil Procedure §580b]

The carryback seller claims anti-deficiency rules do not bar him from obtaining a money judgment on the carryback debt since the debt became secured by real estate other than the property sold.

Can the seller enforce collection of a carryback debt which was secured, separately or collaterally, by property other than the property sold?

Yes! The seller can obtain a money judgment to enforce collection on the note even though it evidences a carryback debt. Anti-deficiency rules do not apply to a carryback debt when the carryback debt is secured solely or cross-collaterally by real estate other than the real estate sold. [**Goodyear** v. **Mack** (1984) 159 CA3d 654]

If the seller was barred from obtaining a money judgment to enforce collection of the carryback note secured by property other than the property sold, the buyer would be improperly allowed to:

- retain the property sold; and
- avoid paying the seller for the property he purchased.

Anti-deficiency rules

To prevent aggravating the fall of real estate values in a recession or depressed economy, buyers of real estate are protected from the additional burden of personal liability on debts classified as *purchase money*.

Two categories of **purchase money** obligations exist:

- a note held by a **lender** and secured by a trust deed on the owner-occupied, one-to-four unit residential real estate acquired by the borrower with the loan proceeds; and
- any note carried back by a **seller** and secured by a lien only on the real estate purchased from the seller. [CCP §580b]

Should a purchase money lender or carryback seller judicially foreclose on the secured real estate, the owner is not liable for any deficiency in the value of the real estate to fully satisfy the debt. [CCP §580b]

Anti-deficiency waiver barred

Consider a carryback seller who attempts to collect on a note which was purportedly converted to recourse paper by the provision of a modification agreement between the buyer and a lender.

For example, a carryback seller holds two purchase money notes for separate debts owed for the unpaid portion of the sales price of real estate. The notes are secured by first and second trust deeds on the real estate sold. Later, the buyer arranges for a lender to refinance the remaining balance unpaid on the carryback seller's first trust deed note.

However, as a condition of the refinancing, the seller must subordinate his second trust deed to the refinancing.

The carryback seller will agree to reconvey his first trust deed and subordinate his second trust deed to the refinancing, if the buyer:

- **personally guarantees** the second trust deed note; and
- signs a **written waiver** of any anti-deficiency protection.

The buyer agrees. The seller executes a specific subordination agreement allowing his original second trust deed to remain a second, junior in priority to the lender's trust deed.

The buyer then defaults. The first trust deed lender forecloses on the property, wiping out the second trust deed held by the carryback seller. The carryback seller seeks to recover the balance due on the now unsecured carryback note.

The seller claims he is entitled to a money judgment on the purchase money debt since the buyer guaranteed the debt and signed a waiver relinquishing his anti-deficiency protection.

The buyer claims the personal guarantee and the waiver of anti-deficiency protection are unenforceable attempts to circumvent anti-deficiency law on a carryback debt which at all times remained secured solely by the property sold.

Can the carryback seller enforce collection on the note and personal guarantee for the balance due on the note?

No! The buyer is not liable on the note or his guarantee since the seller's carryback debt remains secured by a trust deed on the property sold. Any agreement under which the buyer purports to waive his anti-deficiency protection without a change in the security is void. [**Palm** v. **Schilling** (1988) 199 CA3d 63]

Allowing carryback sellers to require a buyer of real estate to personally guarantee a nonrecourse debt defeats the purposes of anti-deficiency statutes. Imposing personal liability on the buyer for what remains a purchase money debt is a violation of *public policy*.

Only a **third party** who executes a guarantee can be personally liable for amounts due on a purchase money note. [See **first tuesday** Form 439]

Modifying the note

Now consider a carryback seller who holds a purchase money trust deed note currently in default.

The seller offers to extend the due date of the note and lower the interest rate and monthly payments. The seller believes a modification constitutes a refinancing of the debt which converts his purchase money note to recourse paper and reduces his risk of loss on default.

Although the seller **substantially modifies** the terms of the note, or replaces the original note with a new note, **the debt** evidenced by the note still remains:

- the balance due on the purchase price of real estate; and
- secured solely by a trust deed lien on the property sold.

Thus, the seller is barred from collecting a deficiency.

Consider a carryback seller whose buyer resells the property on terms calling for his buyer to take over the carryback note. The seller accepts an assumption and alters the terms of the purchase money note to facilitate the resale of the real estate.

However, should the resale buyer who executed the assumption or modification (or guarantee) default, the carryback seller is still barred from collecting a deficiency. The note still evidences a purchase money debt — a carryback debt which is secured solely by the property sold. Thus, the debt remains a nonrecourse debt for which the assuming buyer on the resale is not personally liable. [**Costanzo** v. **Ganguly** (1993) 12 CA4th 1085]

Now consider a seller who carries back a note secured by a second trust deed on property he sold. Later, the buyer of the property defaults on the note.

The buyer and carryback seller modify the note to include a **clause waiving** the buyer's anti-deficiency rights. Ultimately, the first trust deed holder forecloses on the property, wiping out the seller's trust deed.

The carryback seller seeks to recover a money judgement on the note since the security has been exhausted.

The buyer claims the seller is barred from any recovery on the note since the carryback trust deed note is subject to anti-deficiency law which cannot be waived as long as the note is secured only by the property sold.

The seller claims the buyer waived his anti-deficiency protection since the waiver occurred on a modification of the original note and trust deed.

Can the seller recover a money judgment on the modified note?

No! Recovery from the buyer on the modified carryback note, secured only by the property sold, is barred by anti-deficiency rules. A waiver of anti-deficiency protection is unenforceable as against public policy. [**DeBerard Properties, Ltd.** v. **Lim** (1999) 20 C4th 659]

Subordination

Construction loans are by their nature precarious arrangements due to the risk the promised improvements may never be completed to create the anticipated property value.

Consider a carryback seller who carries back a trust deed and later subordinates the trust deed to a construction loan.

Should the construction lender foreclose and wipe out the now subordinated carryback seller's trust deed lien, the seller can collect on the carryback note by obtaining and enforcing a money judgment.

For example, a carryback seller subordinates his trust deed to a construction loan. The loan will fund the cost of improvements to be made on the property he sold. Since the carryback trust deed is subordinated to the loan, the risk of loss due to a failure of the development is thrust upon the seller. To cover the added risk of loss, the note's interest rate is increased and prepaid for the period of construction.

Further, the trust deed note automatically becomes recourse paper on subordination to the construction loan. The seller is not expected to assume the risk the value of the promised improvements may prove to be inadequate security.

Thus, the developer/buyer who promises improvements as additional security is not protected by anti-deficiency rules. As recourse paper, the seller is allowed to collect The unpaid portion of his carryback note from the developer if the property value proves insufficient to satisfy the carryback note. [**Spangler** v. **Memel** (1972) 7 C3d 603]

An agreement to subordinate a carryback trust deed to a future construction loan does not itself cause the trust deed note to lose its nonrecourse character. However, the note becomes recourse paper at the time the carryback trust deed is actually subordinated to a construction loan.

Conversely, the actual subordination of a carryback trust deed to the buyer's purchase-assist trust deed loan, or a later refinancing of the senior trust deed loan, does not present a change in the use or nature of the property sold. Thus, subordination to refinancing does not convert a nonrecourse note to recourse paper. The physical property sold and held as security remains the same. Not so for the seller's position on title since he has altered his loan-to-value ratio (LTV) by accepting a secured position which overencumbers the property. [**Shepherd** v. **Robinson** (1981) 128 CA3d 615]

When a carryback seller agrees to subordinate his carryback trust deed to purchase-assist financing secured only by the property sold, the subordination does not alter the character of the property sold (no

Letters of credit

A lender might require a borrower to obtain a letter of credit as a condition for funding a **purchase-assist loan**. Also, a seller agreeing to carry paper might demand a letter of credit as additional security.

The lender or carryback seller can draw on a letter of credit before or after a trustees sale without violating anti-deficiency statutes or the security first rule. [CCP §580.5(b)]

However, the letter of credit is unenforceable if:

- the obligation is secured by a purchase money trust deed on owner-occupied, one-to-four unit residential property, and
- the letter of credit is issued to a trust deed beneficiary to cover a future default on the obligation. [CCP §580.7(b)]

Thus, a carryback seller or a purchase money lender on an owner-occupied, one-to-four unit residential property is barred from drawing on a letter of credit at any time.

construction promised) or the nonrecourse nature of the seller's (undersecured) purchase money note. [**Lucky Investments, Inc.** v. **Adams** (1960) 183 CA2d 462]

A seller who carries back a trust deed secured only by a subordinated interest in the property sold is charged with knowing the value of the real estate sold and thus the value of the position accepted as security.

For example, should a lack of value exist or a market-induced reduction in the value of the property sold occur due to overpricing or a recession, the buyer is not personally liable on a seller carryback note secured by the property sold even if the debt is later subordinated to new financing. [**Brown** v. **Jensen** (1953) 41 C2d 193]

Choice-of-law avoids anti-deficiency law

Consider a buyer who executes a *purchase money* note secured by a trust deed on California real estate. The note and trust deed contain a provision which adopts the laws of another state to control the legal consequences of the transaction.

The buyer and the carryback seller are both *domiciled* in a state which does not have anti-deficiency laws.

The buyer defaults on the loan. The seller judicially forecloses on the property and is awarded a deficiency judgment.

The buyer claims the seller is barred from recovery by way of a deficiency judgment since the note is secured by California real estate.

The seller claims it is not barred from seeking a deficiency judgment since the transaction is governed by out-of-state law which does not prohibit deficiency judgments.

Is the seller entitled to a deficiency judgment?

Yes! The trust deed contained a choice-of-law provision which controlled enforcement of the California purchase money note under out-of-state law. Since all parties involved were non-residents and located out-of-state, California's public policy regarding anti-deficiency is not adversely affected. Thus, the deficiency in the value of the property sold is collectible by a money judgment. [**Guardian Savings and Loan Association** v. **MD Associates** (1998) 64 CA4th 309]

Note — The Guardian *court's holding is limited to the narrow facts of this case — all parties were non-residents living out-of-state who choose to abide by the laws of a "recourse state." Conversely, to allow choice-of-law provisions applying the law of a recourse state to prevail in California would impermissibly open the door for out-of-state lenders to circumvent California's anti-deficiency laws designed to protect the residents of California*.

Reconveying the trust deed

A lender or carryback seller holding a note secured by a trust deed cannot **unilaterally** waive and reconvey the note's security, then proceed against the borrower or buyer as though the now unsecured note was converted to recourse paper by the *release of the security*.

A *waiver* of the security must be mutually agreed to between the lender and borrower for the secured debt to become a recourse debt.

For example, a carryback seller holds a note for the balance due on the purchase price of real estate. The note is secured by a second trust deed on the property sold.

The property has declined in value to below the amount owed on the note, due to a destabilized real estate market.

The buyer defaults.

For fear of being wiped out should the first trust deed holder foreclose, the carryback seller agrees with the buyer to modify the terms of the note and "release the security."

As agreed, the carryback seller reconveys the trust deed and the carryback note becomes unsecured. [See **first tuesday** Form 472]

The Modification of the Promissory Note, executed by the buyer in favor of the seller, is attached to the note stating the changes in its terms and the release of the trust deed lien by reconveyance. [See **first tuesday** Form 425]

Later, the buyer defaults on the now unsecured note held by the carryback seller.

The carryback seller sues the buyer for a money judgment to recover the balance due on the note.

The buyer claims anti-deficiency rules bar the carryback seller from collecting on the note since the seller's note was a purchase money obligation created to finance the sale of the property.

However, the anti-deficiency rules no longer apply to the carryback note. The buyer and seller **mutually agreed** to a reconveyance of the trust deed and release of the security.

The carryback seller can pursue the buyer to collect the balance due on the note since the security was released by mutual agreement.

To bar a seller from collecting on an unsecured carryback note — a note which is unsecured by mutual agreement between the seller and the buyer — would not advance the purposes of anti-deficiency rules. The buyer would be able to keep the property and pay less than the agreed-to price.

In contrast, a carryback trust deed note which becomes unsecured by mutual agreement is distinct from a carryback note which was unsecured from the outset of the sales transaction — even though both are recourse notes.

A seller who carries back an unsecured note on the close of a sales transaction has a *vendor's lien* which he can impose on the property sold and foreclose. The carryback note must at all times be **unsecured** and represent the amount of the purchase price remaining unpaid. Thus, the note held by the previously secured carryback seller does not qualify for a vendor's lien.

In addition, a carryback seller or lender who requires a buyer to execute two notes for the **same debt**, one secured by the real estate purchased, the other purportedly unsecured, is barred from collecting a deficiency. The *underlying debt*, evidenced by the two notes, is secured by the property sold. Thus, the debt is a nonrecourse debt which can only be collected from the value of the property sold. [**Freedland** v. **Greco** (1955) 45 C2d 462]

Additional security

Now consider a lender who holds a purchase money note. The loan was a purchase-assist loan secured by a first trust deed on owner- occupied, one-to-four unit residential property. Local real estate values have become depressed, causing the real estate to become inadequate security for the note.

When the owner defaults on the note, the lender and owner mutually agree:

- the terms of the note will be modified; and
- the owner will execute a trust deed to additionally secure the note by the owner's other property.

Later the owner defaults again. The lender judicially forecloses on both the owner's personal residence and the additional security, yet a deficiency in value still exists leaving the note unsatisfied.

Can the lender obtain a money judgment to collect the deficiency after judicially foreclosing on both the property sold and the additional security provided by the buyer?

Yes! Anti-deficiency rules do not bar the lender from a money judgment when the note becomes additionally secured by other property. The note no longer is purchase money paper. [CCP §580b]

However, a lender or carryback seller seeking a money judgment on recourse paper must foreclose on all of the security in one judicial action. [CCP §726(a)]

Chapter 39 — The deficiency in recourse loans

This chapter presents the formula for setting the deficiency in a lender's security and addresses the unrecoverable loss on an underbid of the fair price.

Set by the value of the security

An owner of real estate defaults on a loan which is evidenced by a note executed or assumed by the owner. The loan is secured by a trust deed on the property and is a *recourse debt*, not subject to the purchase money anti-deficiency defense.

However, the current resale value of the property has declined below the unpaid loan amount due to *asset price deflation* in the local real estate market.

The lender commences a judicial foreclosure so he can later obtain a money judgment against the owner for any deficiency which may still exist in the property's value at the time of the foreclosure sale.

The property is ordered sold to satisfy the debt. The successful bidder at the judicial foreclosure sale acquires the property for a price less than the amount owed on the debt, called an *underbid*.

A deficiency judgment hearing will set the amount by which the property's fair market value fails to cover the total debt, less any liens with priority, on the date of the foreclosure sale.

Both the lender and the owner retain appraisers to establish the fair market value of the property on the date of the sale.

The appraiser for the owner develops a fair market value for the property based on historically normal market conditions. The appraisal is an effort to establish the *intrinsic value* of the property on the date of the foreclosure sale. The appraiser disregards, as transitory, the real estate and financial market conditions which caused a decrease in the property's cash value to the level existing at the time of foreclosure.

In contrast, the appraiser for the lender sets the fair market value of the property based on the *cash value* of the property in the local real estate market on the date of the foreclosure sale.

The owner claims the deficiency amount to be awarded the lender should be based on the intrinsic value of the property on the date of the foreclosure sale, without any consideration for adverse real estate market conditions which temporarily affect the property's cash value.

The lender claims the amount of the deficiency must be calculated based on the cash value of the property on the date of the foreclosure sale.

Is the lender's cash value appraisal of the property the correct formula for setting a deficiency?

Yes! A deficiency judgment is based on a cash value (as though it were unencumbered) of the secured real estate consistent with market conditions at the time of the foreclosure sale, called the *fair market value* of the property. The deficiency judgment is not based on historical, normal or intrinsic values to which the market value of the property may return. [**San Paolo U.S. Holding Company, Inc.** v. **816 South Figueroa Company** (1998) 62 CA4th 1010]

The foreclosure-deficiency process

On a default under a trust deed, foreclosure procedures allow the trust deed holder to satisfy the secured debt by selling the **real estate interest** which is the security encumbered by the trust deed lien.

Foreclosure on the property described in the trust deed is accomplished by one of two procedures:

- a judicial foreclosure, sometimes called a *sheriffs sale*; or
- a privately arranged, nonjudicial foreclosure, called a *trustees sale*. [Calif. Code of Civil Procedure §725a]

When the trust deed holder seeks a money judgment on a recourse debt, the person owing the debt can require the trust deed holder to **first foreclose** and exhaust all the security described in the trust deed. [CCP §726]

To *exhaust the security* and obtain a money judgment, the lender is limited to a judicial foreclosure sale, unless the trust deed has been wiped out by the foreclosure of a prior lien.

For instance, a reversal in the real estate and financial market drives the value of real estate encumbered by a recourse debt below the amount owed on the debt.

On a default, the secured creditor, a lender, chooses to judicially foreclose and recover the difference through a money judgment, called a *deficiency*.

A judicial foreclosure sale is held. Later, the lender is awarded a money judgment against the borrower who signed or assumed the note secured by the property sold.

The amount of the money judgment is the deficiency in the market value of the property on the date of the foreclosure sale resulting from the property's failure to cover all sums then owed on the debt. [CCP §§580a; 726(b)]

In contrast, the trustees foreclosure process allows the secured real estate to be sold at a public auction, under a private agreement between the lienholder and the property owner, called a *power of sale provision*.

However, a lender who forecloses by a trustees sale is barred from obtaining a money judgment for any loss on the loan arising out of a deficiency in the value of the secured real estate due to market conditions. [CCP §580d]

The anti-deficiency bar

On debts classified by anti-deficiency rules as *purchase money*, a deficiency judgment is barred under either foreclosure process, judicial or nonjudicial. [CCP §580b]

Purchase money debts are grouped into two categories:

- any loan which funds the purchase and is secured solely by one-to-four unit residential real estate **bought and occupied** by the borrower, typically called a *purchase-assist home loan*; and
- any credit extended to a buyer by a seller of any real estate to defer payment of the sales price and **secured solely** by the real estate sold, also called *carryback paper* or *seller financing*. [CCP §580b]

The property securing a purchase money debt is the sole source of recovery for a loss triggered by asset price deflation.

The deficiency judgment

A *deficiency hearing*, which must be noticed within three months after the foreclosure sale, will set the amount of the deficiency. [CCP §§580a; 726(b)]

The calculation for a deficiency judgment is based on the difference between:

- the entire amount of the debt under the note and trust deed on the date of the judicial foreclosure sale; and the **greater of**
- the fair market value of the property on the date of the foreclosure sale less any amounts owed on liens senior to the trust deed; or
- the amount paid for the property at the judicial foreclosure sale. [CCP §580a]

The lender will be awarded a money judgment for the portion of the debt not covered by the *fair price* of the lender's secured position on title.

The lender and the borrower present evidence at the hearing to establish the property's fair market value. Evidence includes opinions of appraisers as to the fair market value of the property. [CCP §§580a; 726(b)]

Also, the court may appoint an appraiser, called a *probate referee*, to advise the court on the value of the property on the date of the sale. [CCP §§580a; 726(b)]

The formula

Consider a lender who judicially forecloses on the security interest it holds in real estate under a trust deed lien. The property is encumbered by unpaid property taxes, liens which the lender does not pay.

At the foreclosure sale, the lender acquires the property, subject to the tax liens, on a credit bid for less than the amount owing on the debt, an *underbid*. The bid is also less than the *fair price* of the lender's security interest in the property.

At the deficiency hearing, the lender is awarded a money judgment equal to the sums of all amounts owed on the note and trust deed, *minus* the cash value of the property on the date of the foreclosure sale, *plus* the unpaid property taxes.

Within one year after the foreclosure sale, the borrower redeems the property for the amount bid by the lender, plus interest from the date of the foreclosure sale.

The redemption amount, due to the lender's excessive underbid, is less than the *fair value* the court set for the lender's security interest, an unrecoverable loss for the lender. The property is still subject to unpaid property taxes.

The borrower now claims the unpaid taxes were improperly added to the deficiency judgment since he will now have to pay them twice:

- once in the deficiency awarded to the lender; and
- again as a lien on the property redeemed.

The lender claims the deficiency is correct since the fair price of its secured position was the property's market value reduced by the tax liens.

The amount set as the deficiency is the correct result, although the mathematical approach was incorrect. The **secured position** held by the lender in the title was subject to property taxes. The unpaid taxes affect the fair price the lender will receive for its security interest in the property since the property's tax liens must be deducted from the fair market value of the property to set the fair price of the lender's security interest. [**Luther Burbank Savings and Loan Association** v. **Community Construction, Inc.** (1998) 64 CA4th 652]

Editor's note — The unpaid taxes were not actually added to the deficiency the lender received.

The taxes were actually deducted from the property's cash value by the court's erroneous reversal of all mathematical signs (plus and minus) in the deficiency formula. The end result must be a negative amount to be a deficiency. The court's mathematical language only appears to add the unpaid taxes to the deficiency.

Thus, the correct approach to calculating the deficiency (a negative amount) is to enter the fair market value of the property and subtract both the tax liens and the remaining debt owed. The negative result is the deficiency awarded the lender.

The fair price

Again, a deficiency judgment is awarded to a lender based on the **unencumbered cash value** of the property which is set consistent with current market conditions on the date of the foreclosure sale, called the *fair market value*. [CCP §726]

Clouds on title, such as a junior lien or a lis pendens, which are wiped out at a foreclosure sale do not affect the property's fair market value. [**Nelson** v. **Orosco** (1981) 117 CA3d 73]

Editor's note — However, a federal tax lien with a 120-day right of redemption may reduce the price a buyer would pay for the lender's position in title since the price paid is the amount the IRS would pay to acquire the property.

However, the price received or the lender's credit bid paid for the property at the foreclosure sale is not considered in setting values. [**Rainer Mortgage** v. **Silverwood, Ltd.** (1985) 163 CA3d 359]

Fair market value is set without concern for any negative impact the foreclosure sale may have on the property's value or the price a prudent buyer would pay at the foreclosure sale for the lender's position in title. [San Paolo, *supra*]

Once the fair market value of the property is determined, the deficiency is the mathematical result of subtracting all prior lien amounts and the amount of the secured debt from the property's fair market value.

If the amount remaining is negative, the lender is awarded a deficiency for the negative amount — the portion of the debt not covered by the **fair price** of the lender's secured position in the property.

Chapter 40 Alternative security devices

This chapter comments on the use of alternative financing arrangements in lieu of a trust deed to mask a sale of real estate.

Creative financing vs. creative chaos

The variables of any financing make up its “creative” aspect, such as its amount, interest rate, payment schedule and due date.

Two sets of forms are used to document the terms of carryback financing which will be junior to any existing trust deed liens:

- a note and trust deed, to evidence and secure the balance of the seller’s **equity remaining** to be paid after the down payment; or
- an all-inclusive note and trust deed (AITD), to evidence and secure the balance of the **price remaining** to be paid after the down payment.

All other forms used for documenting the terms of carryback financing offer not creative financing, but creative **chaos**, both legal and financial.

Seller financing consists solely of arranging the financing of real estate. It does not include the creation of **alternative documentation**, sometimes called *masked security devices*.

Creating new forms, using forms which serve a different purpose than a trust deed (such as a lease-option) or using forms which have outlived their once useful purpose (such as an obsolete land sales contract) is the primary cause of creative chaos and mistaken beliefs.

Documents developed for otherwise legitimate business purposes are occasionally substituted for notes and trust deeds to set up a *smoke screen* in an attempt to avoid due-on enforcement, reassessment for property tax purposes, profit reporting and the buyer’s right of reinstatement or redemption on a default.

Alternative documentation for a carryback sale includes such instruments as:

- land sales contracts, sometimes called *contracts for deed* [See Form 165 accompanying this chapter];
- long-term escrows with interim occupancy;
- unexecuted purchase agreements with interim occupancy, sometimes called *lease-purchase agreements*;
- lease-option sales contracts [See Form 163 accompanying this chapter]; and
- reverse trust deeds coupled with one of the above.

Masking the obvious sale

During periods of rising interest rates and decreasing sales, when the frequency of lender due-on enforcement also tends to rise, these alternative financing techniques share a common strategy of creating trappings that **mask the existence** of a sale in order to avoid due-on enforcement. In the mashing process, reassessments for an increase property taxes do not automatically occur.

Federal legislation allows a lender to call or recast a loan on the transfer of any property interest, including a sale, a transfer of any possessory interest, a further encumbrance or a foreclosure of the property, whether recorded or not. [12 Code of Federal Regulations §591.2(b)]

Notable exceptions allow leases of three years or less on any property (without a purchase option), and further encumbrance of owner-occupied, single-family residences (SFRs) to escape due-on enforcement.

Since attempts to hide sales from the lender and county assessor usually involve the use of alternative security devices, inherent financial disadvantages exist from the outset of the transaction.

Additionally, by changing the intended use of legitimate documents, the legal rights of the parties to the transaction become different from the rights permitted by the use for which the document was originally drafted.

With most alternative security arrangements, the new owner/buyer fails to become the owner of record and often fails to exercise the full benefits of ownership, such as interest/depreciation deductions and the right to sell or further encumber the property.

Hiding the purchase from the lender hides it from everyone, including the Internal Revenue Service (IRS), Franchise Tax Board (FTB), assessors and creditors.

Other disadvantages exist for owner/buyers who use alternative carryback devices in lieu of a note and trust deed, such as the **lack of recording** the documents and the loss of the benefit extended to recorded documents, as well as the lack of title insurance. If a carryback transaction is to go **unrecorded, unescrowed and uninsured**, at the very least the proper documents should be used — a grant deed, trust deed and note — to avoid compounding the failure to record and obtain a title insurance policy by using chaotic documentation.

Contract for deed: the land sales contract

The **land sales contract** was widely used from the late 1960s to the late 1970s as the preferred method for avoiding due-on enforcement by lenders.

The financing arrangement is deceptively simple. A buyer and seller enter into a contract for the sale of property. The buyer takes possession of the property and makes payments according to the terms of the contract. The transaction typically lacks a formal escrow, title insurance and full disclosures of property conditions.

Title does not formally pass hands until the buyer pays the seller in full.

One might argue the existing lender of record has no cause to call the loan since the record of ownership of the property does not officially change until the contract is fully performed. However, this argument fails. An *equitable conversion* of ownership does occur since the seller is only entitled to money, not a return of the property except by foreclosure. Thus, the buyer becomes the *equitable owner* of the real estate with the **right of redemption** to pay all sums due the seller and get clear title. [**Tucker** v. **Lassen Savings and Loan Association** (1974) 12 C3d 629]

However, as straight forward as the land sales contract may sound, it has proven to be an extremely fragile economic and legal affair.

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street
Address

City &
State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

LAND SALES CONTRACT

All-Inclusive with Power of Sale

Items left blank or unchecked are not applicable.

This Agreement, made this ______________ day of _____________, 20______, between
____, called Vendor, and
____, called Vendee,
whose address is ____,
(number and street) (city) (state) (zip)

Regarding the real property in the City of ____,
County of ____, California, described as:

1. Subject to the following trust deeds and notes referred to as Underlying Obligations:

1.1 A trust deed recorded __________________, as Instrument No. _____________ in Official Records of _________________________ County, California, executed by ___________________________________ as Trustor, in which ____ is Beneficiary, securing a note in the original amount of $_______________ with an unpaid balance of $_______________ payable in installments of $_______________ monthly including ______ percent annual interest ☐ ARM, ☐ plus payments for impounds.

1.2 A trust deed recorded __________________, as Instrument No. _____________ in Official Records of ____________________________ County, California executed by _______________________________ as Trustor, in which __________________________ is Beneficiary, securing a note in the original amount of $_______________ with an unpaid balance of $_______________ payable in installments of $_______________ monthly including ______ percent annual interest, all due ____________________.

1.3 ☐ See attached addendum for additional Underlying Obligations.

1.4 Vendor to remain responsible for and to pay all amounts called for in the Underlying Obligations.

2. Vendee hereby purchases the property for the price of . . . . $________________

2.1 The cash down payment on the price on entering into this agreement is the amount of. . $________________

2.2 The balance of the purchase price is the sum of . . . . $________________ bearing interest from date of ☐ agreement, or ☐ __________________________, on unpaid principal at the annual rate of ______ percent, payable in installments of $________________, or more, on the ______ day of each consecutive month beginning on the ______ day of _____________________ and continuing until ______________, 20______ when the principal is due and payable.

3. Vendor retains legal title for the purpose of securing payment of:

a. The balance of the purchase price;

b. Any additional sums and interest hereafter loaned by Vendor to the Vendee, or their assignee, evidenced by a promissory note or notes, referencing this agreement as security for payment;

c. The Vendor's charge for a statement regarding the secured obligations requested by or for Vendee; and

d. The performance of each provision contained in this agreement.

VENDEE AGREES:

4. Condition of Property — To keep the property in good condition and repair; not to remove or demolish any building; to complete and restore any building which may be constructed, damaged or destroyed; to comply with all laws affecting the property or requiring any alterations or improvements to be made; not to commit or permit waste; to cultivate, irrigate, fertilize, fumigate, prune and do all other acts which from the character or use of the property may be reasonably necessary.

5. Hazard Insurance — Vendee will continuously maintain hazard insurance against loss by fire, hazards included within the term "extended coverage," and any other hazards for which the Vendor requires insurance. The insurance shall be maintained in the amounts and for the periods the Vendor requires. The insurance carrier providing the insurance shall be chosen by Vendee, subject to Vendor's approval, which shall not be unreasonably withheld. All insurance policies shall be acceptable to Vendor, and contain loss payable clauses in form acceptable to Vendor. Vendor shall have the right to hold policies and renewals.

In the event of loss, Vendee shall promptly notify the insurance carrier and Vendor. Vendor may make proof of loss if not made promptly by Vendee. Vendor may place the proceeds in a non-interest bearing account to be used for the cost of reconstruction of the damaged improvements. If Vendee fails to reconstruct, Vendor may receive and apply the loan proceeds to the principal debt hereby secured, without a showing of impairment.

6. Indemnity — To appear in and defend any action or proceeding purporting to affect the security, or the rights and powers of Vendor; and to pay all costs and expenses.

7. Taxes and Senior Encumbrances — To pay: all taxes and assessments affecting the property, including water stock assessments at least 10 days before delinquency; all encumbrances, charges and liens, with interest, on the property when due, which are not the responsibility of the Vendor and are or appear to be senior to this agreement; and all expenses of this agreement.

8. Acts and Advances to Protect the Security — If Vendee fails to make any payment or to perform any act provided for in this agreement, then Vendor may, at the option of the Vendor and without notice, and without releasing Vendee from any obligation under this agreement:

a. Make or do the same to the extent necessary to protect the security, Vendor being authorized to enter upon the property to do so;

b. Appear in or commence any action or proceeding purporting to affect the security, or the rights or powers of Vendor;

c. Pay, purchase, contest or settle any encumbrance, charge or lien that appears to be senior to this agreement.

In exercising the power of this provision, Vendor may incur necessary expenses and reasonable attorney fees. Vendee to pay immediately all sums expended by Vendor provided for in this agreement, with interest from date of expenditure at the same rate as the principal debt hereby secured.

VENDOR AND VENDEE AGREE:

9. Assignment of Damages — Vendee assigns to Vendor any award of damages made in connection with:

a. Condemnation for use of or injury to the property by the public, or conveyance in lieu of condemnation; or

b. Injury to the property by any third party.

10. Waiver — By accepting payment of any sum due after its due date, Vendor does not waive Vendor's right to either require prompt payment when due of all other sums or to declare default for failure to pay. Vendor may waive a default of any provision of this agreement, by consent or acquiescence, without waiving any prior or subsequent default.

11. Conveyance of Title — Vendor to convey title free of creditor's liens, subject to existing CC&Rs, to Vendee upon Vendee's payment of all sums due to Vendor under this agreement.

11.1 On conveyance of title from Vendor to Vendee on full performance of this agreement by Vendee, the interest of Vendor and Vendee in the property will be insured by a title insurance policy issued by ________________________ Title Insurance Company, premium to be paid by ☐ Vendor, or ☐ Vendee.

11.2 On Vendee's deposit into escrow of all sums and instruments due to Vendor under this agreement and payment of all customary escrow costs and charges, Vendor to deposit into the escrow all instruments and instructions necessary to convey title and fully perform this agreement.

12. Due-on-sale — Should Vendee sell, transfer or convey any interest in the property, legal or equitable, either voluntarily or by operation of law, Vendor may, at Vendor's option, declare all sums secured by this agreement immediately due and payable.

13. Assignment of Rents — Vendee hereby assigns and transfers to Vendor all the rights, title and interest in rents generated by the property, including rents now due, past due or to become due under any use of the property, to be applied to the obligations secured by this agreement.

Prior to a default on the trust deed by the Vendee, Vendee shall collect and retain the rents. On default by Vendee, and without the necessity of the Vendor to make demand or take possession of the property in person, by agent or by court appointed receiver, Vendor shall immediately be entitled to possession of all unpaid rents.

14. Acceleration — If payment of any indebtedness or performance of this agreement is in default, then Vendor may at Vendor's option, without notice, declare all sums secured immediately due and payable by:

a. Commencing suit for their recovery by foreclosure of this lien; or

b. Delivering to Trustee a written notice declaring default with demand for sale; a written notice of default and election to sell to be recorded.

15. Power of Sale — On default under any obligation of this agreement and acceleration of all sums due, Vendor may elect to proceed with a power of sale by a trustee substituted under Civil Code §2934a, noticed and held in accordance with California Civil Code §2924 et seq.

15.1 The undersigned Vendee requests a copy of any Notice of Default and of any Notice of Sale hereunder be mailed to Vendee at the address herein set forth.

16. Prepayment Penalty — Any principal paid in addition to regular installments will, if so requested by Vendee, be paid by Vendor to holders of Underlying Obligations for a reduction in the principal. If the holders are entitled to a prepayment penalty, Vendee shall pay the amount to Vendor for payment of the penalty. The prepayment penalty will not reduce the unpaid balance of principal or accrued interest on the debt remaining on this agreement.

17. Cure of Default — If Vendor defaults in his performance on this agreement, including payment of the Underlying Obligations, Vendee may cure the default and credit the payments against the principal and interest due under this agreement, or recover from Vendor, on demand, the amount of the payments including interest thereon at the note rate.

18. Successors, Assigns and Pledgees — This agreement is for the benefit of, and binds all parties, their heirs, legatees, devisees, administrators, executors, successors and assigns. The term Vendor shall mean the holder and owner of the agreement, or, if the agreement has been pledged, the pledgee.

19. Vendee's Offset Statement — Within 10 days of Vendee's receipt of a written request by Vendor, Vendee shall execute a written estoppel affidavit identifying for the benefit of any assignee or successor in interest of the Vendor: the then owner of the secured property; the terms of the secured debt, including its remaining principal balance; any taxes or assessments due on the secured property; that the secured debt is valid and the Vendee received full and valid consideration for it; and that the Vendee understands the debt and this agreement are being assigned.

20. Final Balloon Payment Notice — This note is subject to Section 2966 of the Civil Code, which provides that the holder of this note shall give written notice to the Vendee, or his successor in interest, of prescribed information at least 90 and not more than 150 days before any balloon payment is due.

21. Addenda — The following checked addenda are a part of this agreement: ☐ Impounds rider for taxes and insurance; ☐ Owner-occupancy rider; ☐ Contract collection rider; ☐ ______________________.

22. Attorney Fees — In any action to enforce this agreement, the prevailing party shall receive attorney fees.

Vendor: ______________________ Vendee: ______________________

Vendor: ______________________ Vendee: ______________________

STATE OF CALIFORNIA ______________________)
COUNTY OF ______________________)
On ______________________ before me,
____
(name of notary public)
personally appeared ______________________
____
______________________,
(*name of principal)*
personally known to me (or proved to me on the basis of satisfactory evidence) to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

WITNESS my hand and official seal.

Signature ______________________

(This area for official notarial seal)

Although a land sales contract with a power-of-sale provision has been accorded the same statutory treatment as a trust deed, courts have given the defaulting buyer under a land sales contract devoid of a power-of-sale provision unequal treatment. Most land sales contracts provide no such power of sale and must be **judicially foreclosed** on a default.

In the past, some courts treated the defaulting buyer as an owner/mortgagor who was entitled to the **reinstatement rights** of mortgage and trust deed law. Other courts viewed the buyer's default as a forfeiture, transforming a would-be owner into a tenant who must pay rent, give up possession, and ultimately face eviction.

A defaulting buyer who has built up a substantial equity under a land sales contract has an unconditional right to complete the purchase by paying the remaining balance, a *redemption.*. However, the buyer has no **right to reinstate** on a default, unless the contract includes the terms for a reinstatement or a trustee's power-of-sale provision. [**Petersen** v. **Hartell** (1985) 40 C3d 102]

The trend is to regard the land sales contract without a power-of-sale provision as a mortgage, which bears no legal difference from a carryback trust deed, except for the lack of a power-of-sale provision and the owner's right to reinstate on a default which accompanies the trustee's foreclosure process. [**Perry** v. **O'Donnell** (9th Cir. 1985) 759 F2d 702]

A basic land sales contract is an agreement to convey title to the buyer when the buyer **fully satisfies** the dollar amount remaining unpaid on the purchase price, sometimes called a *contract for deed*. [See Form 165]

Also, to fit within the statutory definition of a land sales contract, the agreement to convey title must not call for the transfer of title until more than one year has passed after the buyer is given possession of the property. [Calif. Civil Code §2985]

The seller, also called a *vendor*, retains legal title under the land sales contract **as security** for the buyer's promised payment of the balance of the purchase price. The buyer, also called a *vendee*, receives possession of the property and becomes the **equitable owner** of the property.

Although the unrecorded land sales contract is often used to mask a sale of real estate, the sale is actually completed when the land sales contract is signed by the parties and delivered to the seller in exchange for the transfer of possession of the property to the buyer. A small downpayment to the seller usually accompanies the transaction.

Conveyance of title to the buyer usually occurs years later when a formal sales escrow is opened to complete the seller's performance of the land sales contract, an event no different in legal and financial effect than the **reconveyance of a trust deed lien** from title.

The **conveyance escrow** is not a "sales escrow" at all. It is merely the means used to pay off and release the seller's security interest in the property under the land sales contract. The seller had retained title to the property as security for the remaining unpaid balance on the credit sale.

The contentious contract

The buyer and seller should determine and analyze the risks and benefits accompanying their use of an unescrowed, unrecorded and uninsured **land sales contract** before they either:

- sign and deliver an offer to purchase on a land sales contract [See Form 167 accompanying this chapter]; or

OFFER FOR LAND SALES CONTRACT

DATE:____________, 20_____, at ____, California

Note: To be used with Land Sales Contract Form 165 published by **first tuesday**.

Items left blank or unchecked are not applicable. References to forms includes their equivalent.

FACTS:

1. Received from Buyer, the sum of $______________ evidenced by ☐ personal check, or ☐ ______________, payable to ____ to be deposited on acceptance of this Offer and to be applied to the Buyer's obligations to purchase on a Land Sales Contract of property situated in the City of __________________________, County of __________________________, California, described as:.

Real property: ____

Personal property: ☐ See attached inventory; ____

2. This agreement is comprised of this three-page form and _____ additional pages of addendum/attachments.

TERMS:

3. **Buyer to purchase the property for the price of** . . . . **$**______________

3.1 The cash down payment on the price on entering into the Land Sales Contract. . . . . . $______________

3.2 The balance of the purchase price is the sum of . . . . $______________ bearing interest from the date of ☐ agreement, or ☐ ____________________, on unpaid principal at the annual rate of _____%, payable in installments of $____________, or more, on the ____________ day of each consecutive month beginning on the ____________ day of ____________, 20_____ and continuing until ____________, 20_____ when the principal is due and payable.

Conditions:

4. This Offer shall be deemed revoked unless accepted in writing ☐ on presentation, or ☐ within _____ days after date, and acceptance is personally delivered to Offeror or Offeror's Broker within the period.

5. The Buyer(s) and Seller(s) hereby approve the Land Sales Contract Form #165 published by **first tuesday** and agree to sign an original copy, held by the Broker, within _____ days of receipt of the prepared Land Sales Contract. The Broker will deliver the signed Land Sales Contract to the Seller and keys/access codes to the Buyer, along with possession, on ____________, 20_____. [**first tuesday** Form 165]

6. Title is subject to current property taxes, covenants, conditions, restrictions, reservations and easements of record. Title is encumbered with the following debt obligations payable by the Seller under the Land Sales Contract:

6.1 Trust deed note with an unpaid balance of $______________, principal and interest payments being an additional $______________ monthly, including interest at _____%, ☐ adjustable, monthly impounds being $______________. The note and trust deed contain provisions for ☐ due-on sale ☐ prepayment penalty of ____________.

6.2 Trust deed note with an unpaid balance of $______________, principal and interest payments being $______________ monthly, including interest at _____%, due ____________, 20_____.

6.3 Bond or assessment liens of record in the amount of $______________.

7. If an **Owner's Association** is involved, ☐ Buyer has received and approves, or ☐ Buyer on acceptance to be handed, copies of the association's Articles, Bylaws, CC&Rs, collection and lien enforcement policy, operating rules, operating budget, CPA's financial review, insurance policy summary and any age restriction statement.

a. No association claims for defects or changes in regular or special assessments are pending or anticipated. Current monthly assessment is $______________.

b. Seller is not in violation of CC&Rs, except ____.

c. Seller to pay association document and transfer fees.

d. Buyer to approve the association's statement of condition of assessments and confirm representations in subsection a. above as a condition for closing escrow.

e. Within ten days of the Buyer's post-acceptance receipt of the Homeowner's Association documents, Buyer may terminate the agreement based on a reasonable disapproval of the documents. [**ft** Form 183]

8. ☐ Buyer to hand Seller a completed credit application on acceptance. [**ft** Form 302]

8.1 Within _____ days of receipt of Buyer's credit application, Seller may terminate the agreement based on a reasonable disapproval of Buyer's creditworthiness. [**ft** Form 183]

9. ☐ Parties to sign attached Land Sales Contract Financial Disclosure Statement. [**ft** Form 309]

10. Seller to furnish prior to transfer of possession:

a. ☐ a structural pest control report and clearance.

b. ☐ a home inspection report prepared by an insured home inspector showing the land and improvements to be free of material defects.

c. ☐ a one-year home warranty policy:

Insurer: ______________________________

Coverage: ______________________________

d. a certificate of occupancy, or other clearance or retrofitting, required by local ordinance for the transfer of possession or title.

11. Seller's *Natural Hazard Disclosure Statement* [**ft** Form 314] ☐ is attached, or ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days of receipt, Buyer may terminate the agreement based on a reasonable disapproval of hazards disclosed by the statement and unknown to buyer prior to acceptance. [**ft** Form 182 and 183]

12. Seller's Condition of Property (Transfer) Disclosure Statement (TDS) [**ft** Form 304]

a. ☐ is attached; or

b. ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days after receipt, Buyer may deliver to Seller or Seller's broker a written notice itemizing any material defects in the property disclosed by the statement and unknown to Buyer prior to acceptance [**ft** Form 269]. Seller to repair, replace or correct noticed defects prior to closing.

c. On Seller's failure to repair, replace or correct noticed defects, Buyer may tender the purchase price reduced by the cost to repair, replace or correct the noticed defects, or close escrow and pursue available remedies. [**ft** Form 183]

13. Buyer acknowledges receipt of a booklet and related Seller disclosures containing ☐ *Environmental Hazards: A Guide for Homeowners, Buyers, Landlords and Tenants* (on all one-to-four units), ☐ *Protect Your Family from Lead in Your Home* (on all pre-1978, one-to-four units) [**ft** Form 313], and ☐ *The Homeowner's Guide to Earthquake Safety* (on all pre-1960, one-to-four units). [**ft** Form 315]

14. ☐ Seller to provide a Request for Notice of Delinquency to underlying lenders. [**ft** Form 412]

15. Fixtures and fittings attached to the property include but are not limited to: window shades, blinds, light fixtures, plumbing fixtures, curtain rods, wall-to-wall carpeting, draperies, hardware, TV antennas, air coolers and conditioners, trees, shrubs, mailboxes and other similar items.

16. Other disclosures:

☐ Industrial use area; ☐ Military ordnance area; ☐ Rental Income Conditions [**ft** Form 255].

17. Smoke detector(s) and water heater bracing exist in compliance with the law, and if not, Seller to install.

18. Both parties reserve their rights to assign and agree to cooperate in effecting an Internal Revenue Code §1031 exchange prior to close of escrow, on either party's written notice. [**ft** Forms 171 or 172]

19. Should Buyer breach the agreement, Buyer's monetary liability to Seller is limited to ☐ $_______________, or ☐ the deposit receipted in Section 1.

20. Notice: The California Department of Justice, sheriff's departments, police departments serving jurisdictions of 200,000 or more and many other local law enforcement authorities maintain for public access a database of the locations of persons required to register pursuant to paragraph (1) of subdivision (a) of Section 290.4 of the Penal Code. The database is updated on a quarterly basis and a source of information about the presence of these individuals in any neighborhood. The Department of Justice also maintains a Sex Offender Identification Line through which inquiries about individuals may be made. This is a "900" telephone service. Callers must have specific information about individuals they are checking. Information regarding neighborhoods is not available through the "900" telephone service.

21. Buyer to obtain hazard and personal liability insurance to cover Buyer's interest in the property.

22. Seller to pay a brokerage fee of $_______________ on entering into the Land Sales Contract and $_______________ on payoff of the balance due on the Land Sales Contract. The Seller's Broker and Buyer's Broker, respectively, to share the brokerage fee _____________:_____________.

23. ☐ See attached Agency Disclosure Addendum. [**ft** Form 305]

Buyer's/ Selling Broker: ______	Seller's/ Listing Broker: ______
By: ______	By: ______
Is the agent of: ☐ Buyer exclusively. ☐ Both Seller and Buyer.	Is the agent of: ☐ Seller exclusively. ☐ Both Seller and Buyer.
I agree to the terms stated above.	**I agree to the terms stated above.**
Date: ______, 20____	Date: ______, 20____
Buyer: ______	Seller: ______
Buyer: ______	Seller: ______
Signature: ______	Signature: ______
Signature: ______	Signature: ______
Address: ______	Address: ______
______	______
Phone: ______	Phone: ______
Fax: ______	Fax: ______
E-mail: ______	E-mail: ______

- sign and deliver the land sales contract and transfer downpayment funds and possession. [See Form 165]

Typically, when a land sales contract is used, the formal aspects of an escrowed sale of real estate are incorrectly deferred until a "sales escrow" is opened to handle the buyer's payoff and the seller's transfer of record title to close out the land sales contract.

The later sales escrow, used to close out the land sales contract, fails to reflect the fact that the actual sale occurred years earlier when the buyer and seller entered into the land sales contract.

What actually takes place when a sales escrow is used to close out the land sales contract is a **refinancing** of the property — a payoff of the carryback debt and a release of the seller's security interest by the further conveyance of title to the buyer.

The sales escrow, opened to close out the land sales contract transaction, is for the purpose of either:

- a full conveyance and refinancing of the property with a new lender who provides funding for the payoff of the debt owed to the seller on the land sales contract; or
- a seller "rollover" of the remaining contract debt into a note and trust deed, executed by the buyer and received by the seller on a transfer of the title to the buyer.

All costs of a conventional closing incurred in a formal sales escrow, also called *transactional costs*, are avoided at the time of entering into a land sales contract. A seller and a buyer choosing to use a land sales contract usually do not formally escrow the land sales contract transaction or obtain title insurance, local government occupancy or retrofit certificates.

The closing costs are actually deferred until a sales escrow is opened to complete performance of the land sales contract and convey title to the buyer.

Closing costs on a sale include escrow fees, recording costs, title insurance premiums, a beneficiary statement and assumption or loan fees. Reassessment and income taxes are soon to follow these fees.

Often the payment of brokerage fees is in large part deferred as a fractional ownership in, or a lien on, the land sales contract until the seller is paid in full through the sales escrow.

Due-on-sale and reassessment

Consistent with their rationale for not recording a land sales contract, a buyer and seller do not request a **beneficiary statement** from the lender or a **waiver** of the lender's right to call or recast the loan on transfer of equitable ownership.

Thus, sellers and buyers often mistakenly believe an unrecorded sale of real estate (such as a sale on a land sales contract), which is not brought to the attention of the lender or the county assessor, does not trigger the *due-on clause* or *reassessment* as a sale and change of ownership.

On the contrary, entering into a land sales contract triggers both the **due-on clause** in an existing trust deed as a transfer of an interest and **reassessment** as a change of ownership, even if the land sales contract document is not recorded.

Whenever the holder of a trust deed containing a due-on clause discovers the secured property has been sold on a land sales contract, the lender can enforce the due-on clause. Likewise, the county assessor can reassess on their discovery of the sale.

Contract escrows for delayed recording

Escrow companies have contributed to the creative chaos scene in the form of the **contract escrow**.

The contract escrow actually involves two escrows.

On the close of the first escrow, the cash down payment is disbursed to a seller. However, all documents normally recorded, such as a grant deed and a trust deed, are placed in a second "holding" escrow. Nothing is recorded, but the proper documentation has been completed.

The sale of property has been closed for purposes of reassessment, due-on-sale and income tax.

The second contract escrow holds the documents until a written request from the buyer or the seller is received by escrow instructing them to record the grant deed and trust deed.

Since both the seller and the buyer have an insurable interest in the property, two separate policies of **fire and hazard insurance** are frequently obtained — one for the seller and another for the buyer. Alternatively, an agreement is entered into by the buyer and seller giving the buyer an interest in the proceeds of the insurance policy.

The carryback note is often placed on contract collection with the same escrow company.

Unexecuted purchase agreements, extended escrows

Similar in approach to the land sales contract is the transfer of possession to the buyer under an **unexecuted purchase agreement**, as a sales escrow will not be closed for an extended period of time.

Here, a **marketing instrument** is used, such as a regular purchase agreement form. The purchase agreement is turned into a **security device** characteristic of a land sales contract or lease-option, with a trans-

fer of possession and the buildup of the buyer's equity through payments to the seller, called a *lease-purchase sale*.

For example, a buyer and a seller sign a standard purchase agreement.

An escrow is opened. A grant deed, a carryback note, a trust deed, and the down payment are deposited into escrow within 30 to 60 days. However, the closing and disbursement of funds are delayed until after one to three years of timely performance by the buyer. During the extended escrow period, payments are made to the seller which include credit of a portion of the amount toward the down payment (or price) called for in the purchase agreement. Often, the buyer's payments are sent to the same escrow that received the down payment and documents.

Since the buyer wants to take possession of the property prior to the close of escrow, he enters into an interim occupancy (lease) agreement with the seller. Neither the lease nor the escrow will extend beyond three years to avoid triggering any due-on clauses.

Should the seller enter into a lease for more than three years or apply payments toward the purchase price, the transfer of possession will qualify as a sale, triggering reassessment, profit tax reporting, the lender's right to accelerate the loan, etc. [12 CFR §591.2(b)]

For the buyer to protect any increase in the property's value which occurred by the end of the occupancy period, the buyer must:

- timely close the long-term escrow;
- renew or extend the lease; or
- find a buyer who will purchase his position.

The lease-option sale

Buyers and sellers of real estate must understand that a sale structured as a **lease-option** transaction is still a sale. The form used to structure the sale does not change a buyer's and seller's rights and obligations which are provided by mortgage and contract law.

Moreover, a seller seeking to disguise a sale as a lease option creates risks that are eliminated by more conventional wraparound formats, like the all-inclusive trust deed (AITD).

A sale documented as a lease and option to purchase typically lacks a **power-of-sale** provision which allows for a trustee's foreclosure — the seller's best remedy to recover the property (title and possession) should the buyer default. [See Form 165 §15]

The lease-option sale usually is not documented through an escrow, nor is there delivery of a grant deed or a note and trust deed. Instead, the buyer will lease the home with an option to purchase it at a **predetermined price**, not a price based on market value at the time of exercising the option.

The down payment, called *option money,* is applied toward the purchase price of the property, should the option be exercised. Similarly, a portion of the monthly payment, called *rent*, will apply as principal paid toward the price on exercise of the option prior to its expiration. Of course, the expiration of the option is the legal equivalent of a due date for payment of the balance of the purchase price. [See Form 163 §15]

However, when a tenant receives credit toward the purchase price on payment of his option money or rent, the lease-option is *recharacterized* as a land sales contract, mortgage or trust deed for all purposes. Also, a carryback sale structured as a lease-option will typically be devoid of a trust deed power-of-sale

provision, prohibiting the seller from rapidly foreclosing by a trustee's sale and wiping out the equity the buyer has paid for and built up in the property.

Except for the absence of legal documentation in the form of a grant deed, note and trust deed, the terms of the lease-option sale have all the **economic characteristics** of a credit sale. There is an agreed-to price, a down payment, monthly rent payments which apply in whole or in part toward principal (the balance being interest) and a due date for the final/balloon payment.

When a buyer in possession of property under an agreement with the seller receives credit toward the purchase price for a portion or all of his payments to the seller, he has built up and established an **equity** in the property. Thus, he has an **ownership interest** which carries with it the *right of redemption* to pay off the seller and get clear title. The buyer's redemption rights can only be terminated by a judicial or nonjudicial foreclosure, or a deed-in-lieu of foreclosure.

A lease-option agreement structured on terms economically consistent with a credit sale (a down payment or credit of payments toward the price) is neither a lease between a tenant and a landlord nor an option to buy. The lease-option sales agreement is a **disguised security device** for credit financing of a sale arranged by a buyer and a carryback seller. [**Oesterreich** v. **Commissioner of Internal Revenue** (9th Cir. 1955) 226 F2d 798]

An actual lease coupled with a separate option to buy is the antithesis of seller financing. A borrower's debt obligations and a lender's foreclosure rights are diametrically opposed to a tenant's leasehold obligations and the eviction rights of a landlord.

Also, all lease-options trigger due-on provisions in trust deeds which encumber property.

Tax aspects

Taxwise, **lease-option sales** are recharacterized by the Internal Revenue Service (IRS), the state Franchise Tax Board (FTB) and the county assessor as carryback financing or land sales contracts.

One reason sellers conceal property sales behind the format of a lease-option is to avoid added tax burdens on a change in ownership. Under an actual option agreement, any option money received by the seller is reported as either **profit or income** when the option is **exercised or expires**, or the property is sold subject to the option.

The seller, disguised as a landlord, will also deduct the amount of the property's annual depreciation to reduce income taxes, until the lease-option is recharacterized by the IRS as a sale.

Buyers are motivated to structure a sale as an unrecorded lease-option to evade property **reassessment** by the county. However, the use of a lease-option to mask a sale has property tax consequences, since the economic characteristics of the transaction constitute a change of ownership, triggering retroactive reassessment when later discovered.

Reverse trust deed

The *reverse trust deed* is often used to provide recorded protection for a buyer's investment in an otherwise unrecorded transfer, such as one involving the two-step contract escrow.

As the name suggests, the economic roles of the buyer and seller in the transaction are reversed.

The buyer documents the amount of the down payment on the property as a loan made to the seller.

LEASE-OPTION

Contract for Deed

DATE:_____________, 20______, at ____,California

Items left blank or unchecked are not applicable. References to forms includes their equivalent.

FACTS:

1. This lease agreement and option to purchase is entered into by Lessor/Optionor and Lessee/Optionee, regarding property situated in City of _____________________, County of ____________________California, described as:

Real estate: ____

____

Personal property: ____

2. This agreement is comprised of this three page form and the following checked attachments:

☐ Tenant's Credit Application [**first tuesday** Form 302]
☐ Residential Earthquake Hazards Report [**ft** Form 315
☐ Occupant's Operating Cost Sheet [**ft** Form 562]
☐ Additional provisions [**ft** Form 250]
☐ California Withholding Declaration [**ft** Form 308]
☐ Condition of Property [**ft** Form 304]
☐ Natural Hazard Disclosure [**ft** Form 314]
☐ Lease-Option Financial Disclosure [**ft** Form 309]
☐ Brokerage Fee addendum [**ft** Form 273]
☐ Lead-based Paint Disclosure [**ft** Form 313]

3. Term of lease:

This lease commences _____________, 20______ and continues until _____________, 20______.

3.1 The lease terminates on the last day of the term without further notice.

3.2 If Lessee holds over, Lessee to be liable for rent at the daily rate of $_______________.

4. Rent: Lessee to pay, in advance, a base monthly rent of $_______________ due on the ______ day of each calendar month.

4.1 Rent to be paid by: ☐ cash, ☐ check, or ☐ cashiers check, at Lessor's address below.

4.2 Rent to be tendered by: ☐ mail, or ☐ personal delivery.

4.3 Lessee to pay a late charge of six percent of all rent amounts due in the event rent is not received within ten days of the due date.

4.4 Lessee to pay $_______________ for each rent check returned for insufficient funds and thereafter pay rent by cash or cashier's check.

5. Additional Rent: In addition to the base monthly rent, Lessee to pay additional monthly rent equal to the increased costs incurred by Lessor after entering into this lease-option, due to:

a. ☐ variable/adjustable interest rate on existing loans secured by the property;
b. ☐ variable/adjustable monthly principal or acceleration of existing loans secured by the property;
c. ☐ property taxes on the property;
d. ☐ fire and extended coverage insurance premiums on the property;
e. ☐ any Homeowners' Association assessments;
f. ☐ any special or improvement assessments on the property; and
g. ☐ any other expenditures required of Lessor to protect his interest.

5.1 The additional monthly rent shall be the actual monthly cost increase and 1/12th of any annual cost increase.

5.2 The additional monthly rent is due on, or beginning with, the monthly rent payment next due following notice to Lessee by Lessor.

6. Utilities: Lessee shall pay all costs of public utilities to the property, including any required deposits, installation, or service fees.

7. Maintenance of Premises: Lessee agrees to maintain and perform all necessary repairs to the property during the lease term at his sole expense.

8. Insurance: Lessee shall maintain at his sole expense, naming Lessor as an additional insured:

8.1 ☐ A standard fire insurance policy with extended coverage, vandalism and malicious mischief endorsements, fully covering the replacement cost of all structures on the property during the entire term of the lease; and

8.2 ☐ Public liability and property damage insurance with a single combined liability limit of at least $300,000 and property damage limits of at least $100,000, insuring against all liability of Lessee arising out of Lessee's use or occupancy of the premises.

9. Use of the Property: The property is to be used only as a private residence occupied by Lessee and for no other purpose. Lessee shall comply with all laws regarding the use of the property, and shall not allow any waste or nuisance to occur on the property.

10. Assignment and Subletting: Lessee shall not assign this lease, nor sublet or encumber any interest in the property without the prior written consent of Lessor. Any transfer of an interest in the property by lessee without the prior written consent of Lessor shall, at the option of Lessor, terminate this lease and call for payment of all sums due.

11. Waiver of Damage: Lessee releases Lessor from liability for loss or damage to Lessee or any property of Lessee caused by water leakage, breaking pipes, theft, vandalism, or any other cause beyond the reasonable control of Lessor.

12. Hold Harmless: Lessee shall indemnify Lessor from liability, damages, and/or expenses arising from the death or injury of any person, including Lessee, or from the damage or destruction of any property, including property owned by Lessee, caused or allegedly caused by some condition of the property, or some act or omission of Lessee or any other person.

OPTION TO PURCHASE:

13. Option Money: Optionor acknowledges receipt of option money in the amount of $_______________ given in consideration for this option to purchase the property leased.

14. Option Period: Optionor hereby grants to Optionee the irrevocable option to purchase the Optionor's right, title and interest in the property under the sales terms for a period commencing with the acceptance of this option and expiring on termination of the lease.

15. Exercise of Option: Optionee may exercise this option during the option period by:

15.1 Preparing and signing escrow instructions with____;

15.2 Depositing cash in escrow of $_______________; and

15.3 Delivering a certified copy of the signed escrow instructions to Optionor within the option period in person or by certified mail.

16. Delivery of Title: Within _____ days after exercise, Optionor and Optionee shall place in escrow all documents and instruments necessary to close escrow.

17. Sale Terms: The purchase price is $______________ Payable:

17.1 ☐ In cash.

17.2 ☐ Down payment in the amount of $_______________.

17.3 The cash price or down payment to be credited for $_______________ of option money paid, and for ______%, or $_______________, of each payment of base monthly rent.

17.4 ☐ Take title subject to, or ☐ Assume, the existing trust deed note with an approximate unpaid balance of $_____________, currently payable $______________ monthly including principal and interest at ______%, ☐ adjustable, monthly impounds being an additional $_______________.

17.5 ☐ Take title subject to, or ☐ Assume, a trust deed note with a principal balance of $_______________, currently payable $_______________ monthly including principal and interest at ______%, due _____________.

17.6 Loan balance differences to be adjusted in: ☐ Cash, ☐ §17.8 NOTE, or ☐ Price.

17.7 ☐ Assume bonds or assessment liens of record in the approximate amount of $_______________.

17.8 A NOTE for the balance of the purchase price in the amount of $_______________, to be executed by Buyer in favor of Seller and secured by a trust deed on the property, payable $_______________ monthly or more, commencing one month after closing, including interest at ______% from closing, due _______________ years after closing.

a. The note and trust deed shall not contain provisions for due-on clause, prepayment penalty, or late charges.

b. ☐ Optionee to provide a Request for Notice of Delinquency to senior encumbrancers. [**ft** Form 412]

c. ☐ The NOTE is an All-Inclusive Trust Deed Note.

d. As additional security, Optionee to execute a security agreement and file a UCC-1 financing statement on any personal property included in the price.

18. General Provisions:

18.1 The prevailing party in any dispute shall be entitled to attorney's fees and costs.

18.2 Optionee's transfer of any interest in this option terminates the option.

18.3 ☐ Lease-Option Financial Disclosure Statement is attached as an addendum. [**ft** Form 309]

18.4 ☐ See addendum for additional provisions. [**ft** Form 250]

— — — — — — — — — — — — — — — — — — — PAGE THREE OF THREE — FORM 163 — — — — — — — — — — — — — — — — — — —

19. Power of Sale: Should this document be characterized as a security device, on default of rental payments or failure to exercise the option the Lessor/Optionor may call all sums due and elect to proceed with a power of sale by a trustee substituted under Civil Code §2934(a), noticed and held in accordance with Civil Code §2924 et seq.

20. Lessor/Optionor Default: Should the Lessor/Optionor default on any obligation impairing the Lessee/Optionee's interest under this agreement, Lessee/Optionee may cure the default and demand reimbursement from the Lessor/Optionor of the amount advanced and if not paid, deduct the amount paid from periodic payments and the purchase price due the Lessor/Optionor.

21. Expiration of Option: This option to purchase shall be deemed expired if not exercised during the option period, and if not previously terminated, shall automatically expire/terminate on _____________, 20______.

22. Brokerage Fee: Optionor to pay brokerages fees of: a. ______% of the option money on receipt; plus b. ______% of each month's base rent on receipt; and c. $_______________ on exercise of the option. Optionor's broker and Optionee's broker, respectively, to share the brokerage fee ______:______.

23. ☐ See attached Agency Law Addendum. [**ft** Form 305]

Lessee/Optionee's Broker: ________________________	Lessor/Optionor's Broker: ________________________
By: ________________________	By: ________________________
Is the agent of: ☐ Lessee/Optionee exclusively, or ☐ both Parties	Is the agent of: ☐ Lessor/Optionor exclusively, or ☐ both Parties
I agree to the terms stated above.	**I agree to the terms stated above.**
Date Signed:_____________, 20______	Date Signed:_____________, 20______
Lessee/Optionee: ________________________	Lessor/Optionor: ________________________
Signature: ________________________	Signature: ________________________
Signature: ________________________	Signature: ________________________
Address: ________________________	Address: ________________________
________________________	________________________
Phone: ________________________	Phone: ________________________
Fax: ________________________	Fax: ________________________
E-mail: ________________________	E-mail: ________________________

The seller, disguised as an owner borrowing money, signs a note for the amount of the down payment and a trust deed in favor of the buyer. The trust deed becomes a lien on the property the buyer is acquiring, hence its name as a reverse trust deed.

When escrow closes on the sale, the buyer's reverse trust deed is recorded (naming him as the beneficiary) and the seller receives the net proceeds from the down payment. The buyer takes possession of the property under a lease signed by both the seller (as the landlord) and the buyer (as the tenant).

All other documents regarding the buyer's **actual** purchase of the property — the executed grant deed and any carryback notes or trust deeds — are left unrecorded and placed into a contract or holding escrow. The escrow agent is **instructed** to hold these documents (together with the note and a request for a reconveyance of the reverse trust deed) until the buyer or seller requests they be recorded.

As a result, the record indicates the seller merely equity-financed his property.

Neither the lender nor the tax assessor are alerted to the transfer as long as the grant deed remains unrecorded and undisclosed. However, both the lender's due-on clause and the assessor's right to reassess have been triggered.

The reverse trust deed takes the place of the Memorandum of Agreement recorded in some contract escrow arrangements.

However, the reverse trust deed presents a degree of financial protection to the buyer. When recorded, it prevents the seller from defeating the buyer's down payment by further encumbering or deeding out the property to a bona fide purchaser (BFP). [**Miller** v. **Cote** (1982) 127 CA3d 888]

Should the seller interfere with the buyer's unrecorded grant deed interest, the buyer can foreclose on the trust deed and wipe out the seller's position.

However, the reverse trust deed is not perfect and has several fatal flaws, both economic and legal.

Economically, price inflation or value appreciation of the property will cyclically outstrip the buyer's ability to protect his equity (due to the historical monetary policy of the Federal government). Should the buyer ever need to foreclose to recover the amount of his down payment, he will only become the legal owner of the property if he is the successful bidder at a trustee's sale.

Of course, the buyer runs the risk of being overbid by other bidders who appear at the sale. At a minimum, the buyer as the foreclosing beneficiary of the trust deed will get back the amount of his original down payment, plus interest.

Legally, the reverse trust deed is even more disenchanting than lost inflation or appreciation. Even if the buyer could bid high enough at the trustee's sale to acquire title, he still stands to lose the property if the senior lender calls the loan, and if unpaid, foreclose.

If the property is an owner-occupied, one-to-four unit residential property, the owner (meaning the seller, not the buyer) can further encumber and avoid a call under the existing lender's due-on clause only if he **continues to occupy** the property. [12 CFR §591.5(b)(1)(i)]

Thus, the very purpose for using a reverse trust deed (to transfer possession without the risk of the due-on-sale/reassessment) renders it **legally useless**, except to foreclose on the property, since the reverse trust deed does not avoid a call or the recasting of the existing financing or a reassessment when the transaction is discovered by the lender or the county assessor.

Taxwise, a reverse trust deed transaction, unless reported as a sale, exposes the seller to liability for **tax evasion** for deliberately restructuring a sale to appear as a non-taxable event (a loan).

The substance and function of the transaction (the sale of the property) supersedes its recorded form (the trust deed loan).

Also, concealing the sale from the county assessor results in the imposition of stiff property tax penalties by the county tax collector. The seller is also faced with penalties for his failure to report profit to the Internal Revenue Service (IRS) and California's Franchise Tax Board (FTB).

Filing the IRS 1099-S

When a formal sales escrow is not used to handle documents and funds on a sale, the person arranging the sale, generally the broker, is required to report the transaction to the Internal Revenue Service (IRS) on a 1099-S form. [Revenue Regulations §1.6045-4(a)]

The IRS recognizes the sale date to be the earlier of the dates on which:

- title is transferred; or
- the economic benefits and burdens of ownership shift from the seller to the buyer. [Rev. Reg. §1.6045-4(h)(2)(ii)]

Typically, reporting the sale to the IRS with a 1099-S form is incorrectly deferred until the title is conveyed to the buyer through escrow on payoff of the land sales contract, lease-option or other masked security device. Here again, escrow improperly collaborates with the seller, buyer and broker to prevent discovery of the previously masked sale by all persons or agencies, even when escrow closes and reports the closing as the date of the sale.

Chapter 41 — Usury and the private lender

This chapter explains the private lender's exemption from usury limitations when using a licensed real estate broker

Use a broker and avoid usury limitations

When a loan is made, the lender charges the borrower **interest** for use of the money during the period lent. However, the amount of interest a private, non-exempt lender can charge is regulated by statute and the California Constitution, called *usury laws*. [Calif. Constitution, Article XV; Calif. Civil Code §§1916-1 through 1916-5]

Today, the remaining goal of usury laws is the prevention of **loan-sharking** by private lenders — charging interest at a higher rate than the rate established by the usury laws. [CC §1916-3(b)]

Usury exemptions spur competition

Adopted in 1918 as a consumer protection referendum, the first California usury laws set the maximum interest rate at 12% for **all lenders**; no exceptions.

During the Depression, legislators noted the adverse effect the even-handed restriction on interest rates was having on the money supply and the economy.

So, in 1934, usury laws were constitutionally amended — lowering the maximum rate to 10% while exempting several classes of significant lenders entirely.

Lenders such as savings and loan associations (S&Ls), state and national banks, industrial loan companies, credit unions, pawnbrokers, agricultural cooperatives and personal property brokers could lend at whatever rate the market would bear without fear of penalty by *forfeiture of interest*.

Exemptions successfully opened the market by increasing the availability of funds and lowering interest rates due to competition.

When money grew tight again in the late 1970s, legislators applied the same strategy to loosen up funds held by individuals in savings accounts, initiating a proposition in 1979.

On passage of the 1979 initiative, real estate loans **made or arranged** by real estate brokers were added to the list of usury-exempt lender situations. [Cal. Const. Art. XV]

The 1979 law also gave the legislature the power to exempt other classes of lenders from usury limits. The legislature has since exempted corporate insurance companies and consumer finance lenders.

Interest paid with goods and services

When a borrower pays interest on a loan he is really paying rent to the lender for use of his money for a period of time. The money lent is fully repaid during or at the end of the period.

Normally, the amount of interest charged is a fixed or adjustable percentage of the amount of money loaned.

Though interest is commonly paid with money, interest may also be paid with property (goods) or services. The many **types of consideration** given for making a loan become part of the lender's yield on the loan. [CC §1916-2]

Thus, interest includes all compensation a lender receives for lending money, whatever its form, excluding reimbursement or payment for loan origination costs and services rendered. [CC §1915]

However, it is common for non-exempt private lenders to attempt to evade the usury law restrictions on interest and taxes by including bonus charges or claiming commission fees for their making the loan.

Any lender can charge the borrower a bonus, commission or discount, or receive services or goods from the borrower. However, charges and receipts are considered interest only when they do not compensate or reimburse the lender for services rendered in the process of originating the loan.

Charges unrelated to loan origination services are added to the interest stated in the note to determine the aggregate yield on the principal. The average annual yield over the **life of the loan** may not exceed the interest rate ceiling of usury laws — unless the loan transaction is exempt. [**Haines** v. **Commercial Mortgage Co.** (1927) 200 C 609]

A lender may charge the borrower for performing services or expenses incurred to originate the loan, without having to include these charges in the interest yield.

As long as the service performed or the expense incurred was necessary to the origination of the loan, the charges do not add to the lender's yield and is not considered interest. [**Klett** v. **Security Acceptance Co.** (1952) 38 C2d 770]

Examples of services and expenses not included in the interest yield include:

- appraisal, escrow and recording fees [**Ex Parte Fuller** (1940) 15 C2d 425];
- negotiation and brokerage fees paid to a third party [Ex Parte Fuller, *supra*];
- administrative costs, such as foreclosing on the defaulted loan or reconveyancing [**Penziner** v. **West American Finance Company** (1937) 10 C2d 160];
- attorney fees for legal services relating to the loan, such as preparation or review of loan documents [**Murphy** v. **Wilson** (1957) 153 CA2d 132]; and
- late charges due on loan default or prepayment penalties. [**First American Title Insurance & Trust Co.** v. **Cook** (1970) 12 CA3d 592]

Setting the interest rate

If the proceeds of a loan, including home equity loans funded by a non-exempt lender, are earmarked primarily for **personal, family**, or **household use** by the borrower, then the maximum annual interest rate is 10% per annum, whether secured or unsecured. [Calif. Const. Art. XV §1(1)]

However, loans made for the improvement, construction, or **purchase of real estate** are subject to a different maximum annual rate of interest over the life of the loan, which is the greater of:

- 10% per annum; or
- the applicable discount rate of the Federal Reserve Bank of San Francisco (FRBSF), plus 5%.

Usury law and real estate loans

Two basic classifications of private loan transactions exist relating to interest rates private lenders may charge on real estate loans:

Determining the discount rate

The discount rate of the Federal Reserve Bank of San Francisco (FRBSF) is the rate they charge member banks for advances.

The discount rate is reviewed no less than once every fourteen days by the Board of Directors of the Federal Reserve Bank of San Francisco. A review can bring a change in the discount rate — depending on how the directors view the economic health of the region, nation and world.

To determine the **maximum interest rate** allowable under usury limitations, the applicable federal rate (AFR) is set for each month. The rate set for a particular month applies to transactions entered into anytime during that month.

The federal reserve discount rate applicable to loans agreed to or funded during a particular month is the San Francisco Federal Bank rate on the 25th day of the previous month.

A loan transaction falls within a particular month based on the date of the earlier of:

- entering into the agreement to make the loan; or
- the funding of the loan.

For example, a private lender signs loan escrow instructions on April 22, agreeing to fund the loan in two weeks, in the month of May. No prior loan agreement exists.

The Federal Reserve discount rate is 7% for April, the month in which the loan escrow instructions (or other loan agreement) were signed — entered into — by all parties.

The interest rate agreed to is 12% — the maximum yield permitted for the month of April (7% plus 5%).

However, on April 25th, the discount rate falls from 7% to 6%. Thus, the FRBSF rate for the month of May is 6%.

Prior to closing in May, the borrower claims his loan interest rate should fall to 11% to reflect the change, because 12% is usurious for the month of funding.

However, 7% was the discount rate in effect on the 25th day of the month preceding the month of April during which the lender committed — by signing the loan escrow instructions or other agreement — to make the loan.

Since the commitment to make the loan occurred earlier than the funding, the rate for the month in which the commitment occurred controls — even though the loan was funded in a following month and was controlled by a different, and lower, rate.

Note — Contingent interest, such as increased interest received on an adjustable rate loan (ARM), is not subject to usury limitations, unless the ARM contained a note rate in excess of usury limitations when originated, or the ARM was designed with an intent to evade usury laws. [**McConnell** v. **Merrill Lynch, Pierce, Fenner & Smith, Inc.** (1978) 21 C3d 365]

- **brokered** real estate loans; and
- **restricted** or **unbrokered** real estate loans.

Brokered real estate loans are exempt from usury restrictions and fall into one of two categories:

- loans **made** by a licensed real estate broker as the private lender who funds the loan; or
- loans **arranged** with private lenders by a licensed real estate broker acting as an agent for compensation.

Restricted real estate loans are all loans made by private party lenders which are neither made nor arranged by a broker.

Note — Private parties include corporations, limited liability companies and partnerships. These entities would not be exempt from usury limitations unless operating under an exempt classification, such as a personal property broker or real estate broker.

The most common restricted loan involves private party lenders, unlicensed and unassisted by brokers, who make secured or unsecured loans.

For example, a borrower contacts a private lender for a loan. The individual lending the money is a licensed **California real estate broker**. The lender loans the funds and the borrower executes a note in favor of the lender, secured by a trust deed on real estate owned by the borrower.

The rate of interest called for in the note is in excess of usury limitations.

The borrower timely repays the note and the lender reconveys the trust deed. The borrower then demands the lender return all interest paid, claiming the loan was a usurious transaction. The lender rejects the interest refund demand, claiming he is a licensed real estate broker and loans made by him from his own funds are exempt from usury laws.

Is the borrower entitled to a refund of the interest paid?

No! The loan was made by a person who was a licensed California real estate broker when the loan was originated. Thus, the loan is exempt from usury limitations. [**Garcia** v. **Wetzel** (1984) 159 CA3d 1093]

Although loans **made or arranged** by brokers are exempt from usury limitations, loans made by an unlicensed private lender to a borrower who is a licensed real estate broker are not exempt, unless a third party who is a licensed broker arranged the loan.

Exceptions for private parties

Private party transactions involving the creation of a debt which avoid usury laws break down into two categories:

- **exempt debts**, involving loans or a forbearance on a loan; and
- **excluded debts**, not involving a loan.

The most familiar of the excluded "non-loans" is the seller carryback, called a *purchase money debt*.

Purchase money notes executed by the buyer in favor of the seller of any real estate, secured or unsecured by the property sold or other property, are not loans of money, but are credit sales.

As a credit sale debt, a seller may carryback a note, secured or unsecured, at an interest rate in excess of the usury limit. The excess rate is enforceable since the debt is not a loan and thus is not subject to usury laws. [See Chapter 44]

Penalties for usury

The most common penalty suffered by a lender for usury is the nullifying of **all interest** for the loan. Thus, the lender is only entitled to a return of the principal advanced on the loan. [**Bayne** v. **Jolley** (1964) 227 CA2d 630]

The lender may also have to pay a usury penalty of treble damages. [CC §1916-3]

Treble damages are computed at **three times** the 'total interest paid by the borrower during the one year period preceding his filing of a suit, plus the period of time until the judgment.

An award of treble damages as a penalty is normally reserved for a lender the court believes took grossly unfair advantage of an unwary borrower. [**White** v. **Seitzman** (1964) 230 CA2d 756]

Attorneys as brokers

Although attorneys are authorized to perform brokerage activities for compensation, an attorney's services rendered arranging a loan are not covered by the broker's usury exemption.

For example, a borrower retains an attorney, who is also a licensed real estate broker, to arrange a loan from a non-exempt private lender to be secured by real estate owned by the borrower.

Between the time the attorney/broker is retained by the borrower and the time the loan is arranged, the broker's license held by the attorney expires. The loan transaction closes before the attorney renews his broker's license. The note is payable in monthly installments of interest only, principal being payable as a final/balloon payment on the due date.

After making several interest payments, the borrower defaults and the lender begins foreclosure.

The borrower claims the loan has a usurious rate of interest since the attorney arranging the loan did not have a valid broker's license when the lender committed to make the loan. The lender claims the loan is exempt from usury laws since the attorney is authorized to conduct, for compensation, all activities requiring a broker's license without first obtaining a broker's license.

Can the borrower avoid all interest payments on the attorney-negotiated loan?

Yes! While attorneys may perform acts requiring a broker's license, attorneys arranging loans without holding a valid broker's license does not bring the loan under the broker's exemption to usury laws. Thus, the loan is usurious since the attorney's brokerage license was expired on the date the loan was agreed to, barring the private lender's collection of interest from the borrower. [**Del Mar** v. **Caspe** (1990) 222 CA3d 1316]

A borrower who knew at all times a loan interest rate was usurious is not likely to be awarded treble damages. Also, a lender who sets a usurious rate in complete ignorance of the illegality of usury would not be additionally penalized with treble damages.

Usurious loans to broker/borrower

Consider an owner of real estate who is a licensed real estate broker and negotiates directly with a private lender to obtain a loan secured by his property.

The interest charged for the loan is at an annual rate in excess of the usury limitation and the loan is negotiated without the services of another real estate broker.

The lender funds the loan escrow. The trust deed is recorded, the note is delivered to the lender and the borrower is handed the net loan proceeds on closing.

When the note becomes due, the owner/broker tenders payment of an amount equal only to the principal advanced by the lender and demands a reconveyance. The owner claims he owes only the principal borrowed and no interest, since the interest rate is usurious.

The private lender claims the loan transaction is exempt from the interest restrictions of California's usury laws since the borrower is a licensed real estate broker.

Is this loan controlled by usury laws if the owner who borrowed the money is a licensed real estate broker?

Yes! The private lender's rate of return on the loan is limited by usury laws, unless the private lender is a licensed real estate broker or a real estate broker is paid to negotiate the loan as an agent of one of the parties. [**Winnett** v. **Roberts** (1986) 179 CA3d 909]

Now, consider a broker who is also a general partner in a partnership. The partnership wants to borrow money to improve real estate it owns.

The broker/general partner negotiates with a private non-exempt lender for a loan which is to be secured by real estate owned by the partnership.

The lender funds the loan. The lender receives the partnership's promissory note and trust deed executed in favor of the lender by the general partner on behalf of the partnership. The rate of interest called for in the promissory note is in excess of usury limitations.

The partnership timely repays the loan and the lender reconveys the trust deed. The partnership then demands the lender return all interest paid on the loan, claiming the loan was usurious.

Is the partnership entitled to a refund of interest paid on the loan?

Yes! The partner is not acting in the capacity of a licensed broker when he negotiates a loan on behalf of the partnership, he is acting as its general partner. [**Green** v. **Future Two** (1986) 179 CA3d 738]

Note — Another California appeals court held in a nearly identical factual situation — tenants in common acting as a group — that the broker acting on behalf of a partnership of which he is a member is considered to be acting for others and thus operating in his licensed capacity. [**Stickel** v. **Harris** (1987) 196 CA3d 575]

However, the court in Stickel *did not have a firm grasp on brokerage law. The analysis in the case is faulty as its conclusion relies on the erroneous assumption a broker's license is required for a general partner to deal with real estate owned by the partnership*.

No fee was received for or was contingent on the act of negotiating the loan for the group. The general partner received only the benefits he would have received as a partner, whether or not this loan was originated. Thus, he did not "arrange" the loan for the group as required to qualify it for exemption from usury laws.

Agents and usury

Activities of a licensed real estate agent are not within the broker's usury exemption, unless the agent is employed by a broker and the agent's level of participation in the transaction constitutes arranging the loan.

For example, an owner wants to refinance a loan secured by real estate he owns. The owner contacts a broker and they discuss acceptable terms for the loan.

However, the broker is unable to find a lender to fund the loan. The broker then informs an affiliate with whom he shares office space about the loan. The affiliate is a licensed real estate agent who is not employed by a broker. The agent locates a lender who funds the loan. The interest rate called for in the note exceeds the rate allowable under usury laws.

The agent is directly paid a fee by the borrower. The agent does not split the fee with the broker, but uses some of his income to pay joint office expenses.

The owner makes all payments due on the loan and the lender reconveys. The owner then demands a refund of all interest paid, claiming the loan was usurious since it was arranged by a licensed sales agent, not a broker.

Is the owner entitled to a refund of the interest?

No! The initial terms for the loan were established with the borrower by the broker. The broker's involvement in the transaction is sufficient for the loan to be considered arranged by a broker. Although the broker did not receive direct compensation from the owner, he did receive indirect compensation for his involvement since the agent contributed to common office expenses. Thus, the loan is exempt from usury limitations. [**Jones** v. **Kallman** (1988) 199 CA3d 131]

Now consider an agent who arranges loans for a non-exempt private lender while employed as an agent of a broker. The agent terminates his affiliation with the broker, but does not inform the lender.

Later, a borrower contacts the now unemployed agent seeking a loan to be secured by real estate owned by the borrower. The salesman arranges the loan which is funded by the private lender. The borrower executes a note and trust deed in favor of the lender. The interest called for in the note is in excess of usury limitations. The borrower pays the salesman a fee.

After making several interest-only payments, the borrower defaults and the lender initiates foreclosure.

The borrower claims he does not owe any interest to the lender, and all interest paid should be credited to principal, since the loan was not arranged by a licensed real estate broker and is thus usurious.

Can the borrower avoid paying any interest on the loan since the real estate salesman was not working for a broker at any time while arranging the loan?

Yes! For a loan arranged by a salesman to be exempt from usury laws, the salesman must be working for a broker while arranging the loan. Since the salesman was not employed by or affiliated with a broker at any time when the loan was being arranged, the loan is not exempt from usury laws. [**Dierenfield** v. **Stabile** (1988) 198 CA3d 126]

Chapter 42 — The all-inclusive promissory note and trust deed rider

This chapter explains the preparation and relationship between the all-inclusive note and the two addenda which convert a trust deed to an all-inclusive trust deed (AITD).

Negotiating interest rates and payments

An all-inclusive note (AITD), also called a *wraparound note* or *overriding note*, is evidence of an **installment debt** created for a buyer's payment of the balance due on the purchase price of real estate after a cash down payment. In turn, the seller retains responsibility for, and makes payments on, the existing trust deed note encumbering the property he sold.

The interest rate charged by the seller carrying back an AITD with a five- to ten-year due date is usually comparable to rates available on new first trust deed financing.

Conversely, the interest rate charged on carryback notes with due dates exceeding five to ten years usually exceeds market rates for new loans. However, rates charged by carryback sellers do vary greatly with the needs and expectations of the individuals in each transaction.

Also, sellers rarely seek points or origination fees as compensation to provide the buyer with AITD financing in addition to an interest rate override on the wrapped loan.

Waiver of due-on clause

The AITD carryback seller agreeing to wrap a first trust deed containing a due-on clause must, during negotiations, anticipate the lender's demand to recast its note by increasing the interest rate, payment amounts or due date.

Prior to closing the carryback sale, the seller may want the lender to waive the lender's right to call the loan on the sale and carryback of the AITD, called a *reverse assumption*.

In exchange for the seller agreeing to a modification of the note and the payment of a fee, the seller will obtain the lender's written waiver of the due-on clause. [See **first tuesday** Form 410]

Thus, instead of the buyer assuming the first trust deed note, the carryback seller remains responsible for payment of the note.

Provisions of the all-inclusive promissory note

*Editor's note — **first tuesday** Form 421 is not created for use without major modification when wrapping a variable rate loan. [See **first tuesday** Form 433]*

When the underlying loan is an adjustable rate mortgage (ARM), the seller must make sure the AITD is adjusted concurrent with adjustments in the underlying ARM to avoid a negative cash flow.

The all-inclusive note is used with either the **equity payoff** or **full payoff** varieties of all-inclusive addenda to a regular trust deed.

Preparing the all-inclusive trust deed note

The following instructions are for the use and preparation of an AITD note, **first tuesday** Form 421. Form 421 consists of provisions from a regular interest-included installment note, modified by adding provisions (sections 3.1 and 3.2) to disclose that the amount of the all-inclusive note includes the balance remaining on one or more underlying loans, the payment of which the carryback seller remains responsible. [See Form 421 accompanying this chapter]

Each instruction corresponds to the provision in the form bearing the same number.

*Editor's note — **Check** and **enter** items throughout the agreement in each provision with boxes and blanks, unless the provision is note intended to be included as part of the final agreement, in which case it is left unchecked or blank.*

Document identification:

Enter the dollar amount of the all-inclusive note, the date the note is prepared and the name of the city where the note is prepared. This information is used when referring to this note and must conform with the dollar amount, date and location entered on the trust deed used to secure this note to real estate.

1. *Promise to pay*: **States** the payor's promise to pay the debt on the terms and provisions contained in the note.

    1.1 *Payee*: **Enter** the name of the person who is to receive the payments, typically the carryback seller, his assignee or a §1031 buyer's trustee. The all-inclusive trust deed identifies the payee as the *beneficiary*.

    1.2 *Place of payment*: **Enter** the city where payments are to be delivered to the payee.

    1.3 *Debt amount*: **Enter** the amount of the principal to be paid on the note.

Editor's note — The principal amount is the same as in section 1 above, unless escrow is instructed to enter a different debt amount on closing due to adjustments in price or down payment.

    1.4 *Interest accrual date*: **Enter** the date interest begins to accrue, usually the date escrow closes.

Editor's note — The closing date of escrow is usually uncertain until it occurs. Thus, the space for commencement of accrual is left blank when the note is prepared. Escrow is instructed to enter the closing date when it is known.

    1.5 *Interest rate*: **Enter** the interest rate negotiated and agreed to in the purchase agreement.

*Editor's note — The all-inclusive note is not formulated for variable interest rates. Use **first tuesday** Form 433 and add all-inclusive provisions noted in instructions for its use.*

2. *Installment payments*: **Enter** the dollar amount to be paid as scheduled installments. If scheduled installments change during the life of the note, also **enter** an asterisk here and at section 5 and, following the asterisk at section 5, **enter** the dollar amount of each change and the date the change will begin.

    2.1 *Payment schedule*: **Enter** the day of the month each payment is due to be received by the holder of the note.

ALL-INCLUSIVE PROMISSORY NOTE
SECURED BY DEED OF TRUST

RECOMMENDED FOR USE WITH **first tuesday** FORM 442/443

$_______________, dated _____________, 20______, at ______________________________________,California,

1. In installments as herein stated, for value received, I jointly and severally promise

1.1 to pay to ____, payee, or order,

1.2 at ____,

1.3 the sum of ____ DOLLARS,

1.4 with interest from __________________, 20______

1.5 on unpaid principal at the rate of _________% per annum.

2. Principal and interest payable in installments of ____DOLLARS

2.1 on the _____________ day of each __________________ month,

2.2 beginning on the _____________ day of___________________, 20________,

2.3 and continuing until _____________, 20______, when the principal is due and payable.

2.4 Principal and interest payable in lawful money of the United States.

2.5 Each payment shall be credited first on interest then due and the remainder on principal.

3. The principal amount of this Note includes:

3.1 The present unpaid balance of $_______________ on a debt evidenced by a note and secured by an existing trust deed held by ____ in the original amount of $_______________, which debt remains the obligation of the payee.

3.2 The present unpaid balance of $_______________ on a debt evidenced by a note and secured by an existing trust deed held by ____ in the original amount of $_______________, which debt remains the obligation of the payee.

4. On default in payment of any installment when due, the whole sum of principal and interest may be called immediately due at the option of the note holder.

5. ____

____

____

____

____

____

____

____

____

6. In any action to enforce this Note, the prevailing party shall receive attorney fees.

7. This Note is secured by a DEED OF TRUST

Payor's Name: _________________________________

Signature: _________________________________

Payor's Name: _________________________________

Signature: _________________________________

Payor's Name: _________________________________

Signature: _________________________________

Payor's Name: _________________________________

Signature: _________________________________

Enter the frequency of payments by stating the number of months separating payments, e.g., "consecutive" when installments are due every month, "other" when bi-monthly, "third" when payable quarterly, "sixth" when payable semi-annually and "twelfth" when payable annually.

Editor's note — A payment is delinquent after the due date, unless a grace period, by statute or by agreement, extends the date on which payments may be delivered to the holder before becoming delinquent.

2.2 *First payment date*: **Enter** the due date (day and month) for the first payment, typically agreed to as 30 days after the commencement of interest, or the first day of the month first following 30 days after the close of escrow in which case escrow credits the seller with interest which will accrue through the end of the month of closing.

2.3 *Date of final installment*: **Enter** the words "until paid" if the carryback is to be fully amortized by constant monthly payments, or the date when any remaining balance is due. If the due date is on an anniversary of the close of escrow, such as five years after close of escrow, **instruct** escrow to enter this date on closing.

2.4 *Form of payment*: **States** the installment payments and final/balloon payment are to be paid in United States dollars.

2.5 *Interest accrual*: **States** the installment payments are to be credited first toward interest accrued and then to principal.

3. *All-inclusive provisions*: **Provides** that the dollar amount of the existing debt encumbering the property is included in the amount of principal of the all-inclusive note.

   3.1 *First underlying encumbrance*: Enter the dollar amount of the principal balance remaining on the first trust deed as of close of escrow, the name of the current lender (beneficiary), and the original dollar amount of the first trust deed. A beneficiary statement should be ordered to disclose this information.

   3.2 *Second underlying encumbrance*: **Enter** the dollar amount of the principal balance remaining on the second trust deed as of the close of escrow, the name of the current lender, and the original dollar amount of the second trust deed note. A beneficiary statement is the primary source for disclosure of this information.

4. *Default provision*: **Provides** for the note holder to declare the entire amount of the note due and immediately payable on failure of the payee to timely pay an installment. However, a properly executed call is unenforceable until the reinstatement period during a foreclosure has expired, except in the case of an incurable breach under trust deed provisions for alienation and waste.
5. *Special provisions*: **Enter** any special provisions to be included in the note, such as a late charge or balloon payment notice.
6. *Attorney fees*: **Provides** for the prevailing party in any litigation on the note to recover his attorney fees incurred in the litigation.
7. *Identification of security*: **States** the note is secured by a trust deed. The link up with the property which is the security is made through the trust deed which references this note by amount, date prepared and city of preparation, naming the original payor and payee of this note as the trustor and beneficiary under the trust deed.

ALL-INCLUSIVE TRUST DEED ADDENDUM

Equity Payoff

DATE:_____________, 20______, at ____, California

RECOMMENDED FOR USE WITH © **first tuesday** FORM 421

Items left blank or unchecked are not applicable.

FACTS:

This is an addendum to the trust deed dated __________________, at ________________________________, California, between ____, Trustor, and ____, Beneficiary.

AGREEMENT:

1. This trust deed is subordinate to the following trust deeds and notes referred to as Underlying Obligations:

1.1 A trust deed recorded on ______________________________, as Instrument No. ___________________, in ____ County Records, California, executed by____as the Trustor, in which ____is the Beneficiary, securing a note in the original amount of $_______________ with an unpaid balance of $_______________, payable in installments of $_______________ monthly, including _______ percent interest, ☐ ARM, ☐ plus impounds.

1.2 A trust deed recorded on ________________________________, as Instrument No. _________________, in ____ County Records, California, executed by ____ as the Trustor, in which ____is the Beneficiary, securing a note in the original amount of $_______________ with an unpaid balance of $_______________, payable in installments of $_______________ monthly, including _______ percent interest, ☐ ARM, all due _____________, 20______.

1.3 Beneficiary to pay all installments and payments called for on the Underlying Obligations.

2. ☐ Check, if applicable:
Trustor to deposit with Beneficiary sufficient funds for the payment of taxes and fire insurance, specifically one-twelfth (1/12) of the annual requirements on each calendar month with installment payment. An advance deposit for such payment in the amount of $_______________ from Trustor has been received by Beneficiary.

3. ☐ Check, if applicable: *[This provision may cause adverse income tax consequences for the beneficiary.]*
The Beneficiary shall place the Note on contract collection with a bank, savings and loan, escrow or broker authorized to do so. Such collection shall disburse the monies received first toward the current installment on the underlying notes, then to taxes and insurance if provided for herein, and any amount then remaining shall be disbursed to the holders of the Note.

4. If Beneficiary defaults in his performance under this trust deed, Trustor, provided that he is not then in default, shall have the right, at his option, to cure Beneficiary's default including the Underlying Obligations by either; (a) crediting any and all such payments against the principal and interest payments next becoming due under the Note, or (b) immediately recovering from Beneficiary the amount of such payments including interest thereon at the note rate.

5. In the event of any monetary default by Trustor, Beneficiary's obligations shall be suspended until the default is cured. If Trustor is delinquent in any payments and Beneficiary consequently incurs penalties or expenses on the Underlying Obligations, the amount of such penalties and expenses shall be added to the Note and be payable by Trustor with the next payment.

6. Any additional principal paid on the Note shall, if Trustor so directs Beneficiary in writing, be paid by Beneficiary to the holders of the Underlying Obligations for credit to the unpaid principal thereof. If the prepayment entitles the holders to receive a prepayment penalty, this amount must then be paid by Trustor to Beneficiary for payment of the penalty. The prepayment penalty shall not reduce the unpaid balance of principal or interest under the Note.

7. In the event of foreclosure of this all-inclusive trust deed, beneficiary will at the Trustee's sale bid an amount representing the amount then due on the obligations secured hereby less the total balance due on Underlying Obligations, plus any advances or other disbursements which Beneficiary may be permitted to include.

8. When the Note becomes due and payable or Trustor requests a demand for payoff, the principal amount then unpaid shall be reduced by the then unpaid balance of the Underlying Obligations.

Preparation of the all-inclusive trust deed addenda

The two variations of the AITD, the **full payoff** and the **equity payoff**, are differentiated by the amount of the payoff demand the carryback seller can request for satisfaction of the all-inclusive note and reconveyance of the AITD. [See Forms 442 and 443 accompanying this chapter]

Each variety is documented by an addendum which is attached to a standard form trust deed, thus converting the trust deed into an AITD.

The two types of AITD addenda contain differing formulas for the amount of the payoff and foreclosure sale demands.

Other than their payoff formulas (sections 7 and 8), the two AITD addenda contain the same information and provisions.

The following instructions are for the use and preparation of AITD addenda to be attached to a regular trust deed. [See **first tuesday** Form 450]

When attaching an AITD addendum to a trust deed, state on the face of the trust deed, "The attached AITD addendum is a part of this Deed of Trust."

Each instruction corresponds to the provision in the form bearing the same number.

*Editor's note — **Check** and **enter** items throughout the agreement in each provision with boxes and blanks, unless the provision is not intended to be included as part of the final agreement, in which case it is left unchecked or blank.*

Document identification:

Enter the date and name of the city where the AITD addendum is prepared. This date is used when referring to this document.

Referenced trust deed:

Enter the same date and name of the city as entered on the trust deed to which this addendum is attached. The same date is also entered on the all-inclusive note.

Enter as the trustor the name of each individual or entity signing the trust deed, typically all persons signing the note, except co-signers.

Enter as the beneficiary the payee named in the note, be it the seller of the real estate, his assignee or the §1031 trustee.

1. *Existing financing*: **Provides** information identifying the existing encumbrances on the property, the principal amounts of which are included in the AITD note amount.

   1.1 *First trust deed*: **Enter** the date the underlying first trust deed was recorded, its instrument number and the county of record.

   Enter the name of the borrower (trustor) and the lender (beneficiary) named in the underlying first trust deed.

   Enter the original amount of the underlying first trust deed, the remaining principal balance, the dollar amount of the monthly payment, the interest rate and any due date.

ALL-INCLUSIVE TRUST DEED ADDENDUM

Full Payoff

DATE:_____________, 20______, at ____, California

RECOMMENDED FOR USE WITH © **first tuesday** FORM 421

Items left blank or unchecked are not applicable.

FACTS:

This is an addendum to the trust deed dated __________________, at ________________________________, California, between ____, Trustor, and ____, Beneficiary.

AGREEMENT:

1. This trust deed is subordinate to the following trust deeds and notes referred to as Underlying Obligations:

1.1 A trust deed recorded on ______________________________, as Instrument No. ___________________, in ____ County Records, California, executed by____as the Trustor, in which ____is the Beneficiary, securing a note in the original amount of $_______________ with an unpaid balance of $_______________, payable in installments of $_______________ monthly, including _______ percent interest, ☐ ARM, ☐ plus impounds.

1.2 A trust deed recorded on ________________________________, as Instrument No. _________________, in ____ County Records, California, executed by ____ as the Trustor, in which ____is the Beneficiary, securing a note in the original amount of $_______________ with an unpaid balance of $_______________, payable in installments of $_______________ monthly, including _______ percent interest, ☐ ARM, all due _____________, 20______.

1.3 Beneficiary to pay all installments and payments called for on the Underlying Obligations.

2. ☐ Check, if applicable:
Trustor to deposit with Beneficiary sufficient funds for the payment of taxes and fire insurance, specifically one-twelfth (1/12) of the annual requirements on each calendar month with installment payment. An advance deposit for such payment in the amount of $_______________ from Trustor has been received by Beneficiary.

3. ☐ Check, if applicable: *[This provision may cause adverse income tax consequences for the beneficiary.]*
The Beneficiary shall place the Note on contract collection with a bank, savings and loan, escrow or broker authorized to do so. Such collection shall disburse the monies received first toward the current installment on the underlying notes, then to taxes and insurance if provided for herein, and any amount then remaining shall be disbursed to the holders of the Note.

4. If Beneficiary defaults in his performance under this trust deed, Trustor, provided that he is not then in default, shall have the right, at his option, to cure Beneficiary's default including the Underlying Obligations by either; (a) crediting any and all such payments against the principal and interest payments next becoming due under the Note, or (b) immediately recovering from Beneficiary the amount of such payments including interest thereon at the note rate.

5. In the event of any monetary default by Trustor, Beneficiary's obligations shall be suspended until the default is cured. If Trustor is delinquent in any payments and Beneficiary consequently incurs penalties or expenses on the Underlying Obligations, the amount of such penalties and expenses shall be added to the Note and be payable by Trustor with the next payment.

6. Any additional principal paid on the Note shall, if Trustor so directs Beneficiary in writing, be paid by Beneficiary to the holders of the Underlying Obligations for credit to the unpaid principal thereof. If the prepayment entitles the holders to receive a prepayment penalty, this amount must then be paid by Trustor to Beneficiary for payment of the penalty. The prepayment penalty shall not reduce the unpaid balance of principal or interest under the Note.

7. In the event of foreclosure of this all-inclusive trust deed, beneficiary will at the Trustee's sale bid an amount representing the amount then due on the obligations secured hereby, plus any advances or other disbursements which Beneficiary may be permitted to include, on which bid Beneficiary to discharge and obtain reconveyance of the Underlying Obligations.

8. When the Note becomes due and payable or Trustor requests a demand for payoff, the principal amount of the payoff shall be the then unpaid principal and interest, and on receipt of payoff funds Beneficiary to discharge and obtain reconveyance of the Underlying Obligations.

Check the appropriate boxes to indicate a variable interest rate or impounds are provided for in the first trust deed note.

1.2 *Second trust deed*: **Enter** the date the underlying second trust deed was recorded, its instrument number and the county of record.

Enter the name of the borrower (trustor) and the lender (beneficiary) named in the underlying second trust deed.

Enter the original amount of the underlying second trust deed, the remaining principal balance, the dollar amount of the monthly payment, the interest rate and any due date.

Check the appropriate boxes to indicate a variable interest rate or impounds are provided for in the second trust deed note.

1.3 *Payment of wrapped loans*: **States** the seller, as the beneficiary of the trust deed remains responsible for payment of the underlying wrapped loans referenced in sections 1.1 and 1.2, subject to the terms of the addendum.

2. *Impounds*: **Check** if monthly impounds will be paid to the seller by the buyer for property taxes and casualty insurance.

Editor's note — If a wrapped loan is impounded, then the AITD should also be impounded.

3. *Contract collection*: **Check** if the seller has agreed with the buyer to place the note on collection with a third party.

Editor's note — The seller should not agree to a contract collection provision if he intends to receive the full tax benefits of an installment sale. The collection agent under a mutual agreement with the buyer is deemed to be the agent of the buyer, thus relieving the seller of responsibility for payments on the underlying loan.

4. *Seller's default/buyer's remedies*: **States** should the seller default on the underlying wrapped encumbrances, the buyer may cure the defaults and make payments directly on the delinquent underlying encumbrance. Payments advanced by the buyer either apply against the agreed-to AITD installments or, alternatively, are refunded by the seller on demand. One is an out-of-pocket setoff, the other is a refund.
5. *Buyer's default/seller's remedies*: **State** should the buyer fail to make payments on the AITD note, the seller is no longer required to make payments on the underlying wrapped encumbrances unless the AITD is reinstated.

Editor's note — Any late charges or foreclosure costs incurred by the seller on the underlying wrapped encumbrances due to the buyer's default in AITD payments are "passed through" to the defaulting buyer as future advances due the seller if the AITD note does not itself contain a late charge provision.

6. *Prepayment penalty pass-through*: **States** a payoff of an underlying encumbrance caused by the buyer or made at the request of the buyer which incurs a prepayment penalty places responsibility for payment of the penalty on the buyer.
7. **Foreclosure bid, equity payoff AITD (Form 442):**

States the seller's demand on foreclosure of the AITD will be the amount of his equity in the AITD. The AITD equity is the difference between the balance remaining on the all- inclusive note and the balance(s) remaining on the underlying encumbrance(s). The buyer at the foreclosure sale will take the trustee's deed subject to the underlying encumbrance(s).

7. Foreclosure bid, full payoff AITD (Form 443):

States, on foreclosure under the AITD, the seller will demand and bid the entire balance of the all-inclusive note. Concurrent with the foreclosure sale, the seller will satisfy and obtain a reconveyance of the underlying encumbrance, unless the seller is the successful bidder and credits himself with the underlying loan amount he assumes.

8. **Payoff demand, equity payoff AITD (Form 442):**

States the payoff demand for reconveyance of the AITD is the difference in the amounts remaining due on the all-inclusive note and the underlying wrapped encumbrances.

8. Payoff demand, full payoff AITD (Form 443):

States the payoff demand for reconveyance of the AITD is the entire principal amount remaining on the all-inclusive note, plus accrued interest, advances and costs. On payoff, the AITD holder will satisfy and obtain reconveyance of the underlying encumbrances.

Chapter 43 An installment sale coupled with a §1031

This chapter demonstrates the opportunities presented in the tandem use of exempt and deferred profit reporting when arranging a carryback note on the sale of property in a partial §1031 reinvestment

Profits: tax exempt and tax deferred

An investor owns and operates a large, income-producing parcel of real estate. Taxwise, the property is classified as both:

- *§1031 investment property*, composed of the ownership of rental properties and portfolio assets, which as **like-kind property** qualifies the profit on its sale for exemption from taxes on reinvestment [Internal Revenue Code §1031]; and
- *rental property*, with its income, profit and losses reported in the **passive income category**, different and separate from portfolio category income (triple-net leased properties, land, trust deed notes, stocks and bonds) and business category income (brokered property management services, motels and hotels).

The investor's property is encumbered by a loan. The loan balance is greater than the investor's depreciated cost basis in the property, a financial condition referred to as *mortgage-over-basis*. In this situation, taxes will adversely affect the net proceeds of a cashed out sale. Further, the greater the loan amount is in excess of the cost basis, the greater the portion of the net sales proceeds is needed to pay the profit tax.

Thus, the investor is left with less after-tax proceeds than had the basis been higher. This diminishing of net proceeds from a sale does not exist when the amount of the debt on the property is less than the remaining cost basis.

However, the adverse tax consequences of a mortgage-over-basis situation are alleviated by carryback financing, and totally eliminated by a fully qualified §1031 reinvestment plan.

Here, the investor wants to sell the property and use the net proceeds to acquire interest-bearing investments. As an alternative, he will accept income-producing real estate that generates a net spendable income and if it requires considerably less time and effort to manage than the property he now owns.

The investor does not need to withdraw cash from a sale. However, he does want to maintain a continuing flow of income, which, unless replaced, will end on the sale of his property.

The avoidance of profit taxes on a sale is another goal the investor would like to meet.

The investor's real estate broker suggests the terms for a sale of the property in the current market could include a carryback note for the balance of the investor's equity after a cash down payment of approximately 20% on the price. The carryback note would in large part also satisfy the investor's cash flow needs.

The carryback note could be structured with monthly installments sufficient in amount to meet the investor's future monthly income requirements over a long period of time, ending on a due date for final payoff. The note would contain a prepayment penalty provision to fund the payment of profit taxes the investor would incur on any early payoff of the carryback note.

The mortgage-over-basis tax burdens

Taxwise, the economic function of the **mortgage-over-basis situation** in a sale where the investor withdraws equity capital by receiving cash or carrying a note in lieu of all cash, leaves the investor with less after-tax sales proceeds than had the cost basis is greater than the principal amount of the loan encumbering the property.

When loans exceed an investor's cost basis in the property, the **entire equity** in the property is profit. Further, and more financially critical, the portion of the **unpaid principal** on the loans encumbering the property is also *profit*. The portion of the principal loan amount that is not profit represents investor's cost basis remaining in the property.

The broker in the prior example properly concludes, due to the mortgage-over-basis situation, that the profit on the sale will cause 100% of the principal in a standard note carried back by the investor to be reported as profit. The result is the same even if the installment sale is combined with the use of the cash proceeds to buy replacement property in a §1031 reinvestment plan. [See **first tuesday** Form 354.5 §2]

The investor is aware the carryback note qualifies for IRC §453 installment sale reporting. Correctly, the payment of taxes on profit allocated to the principal amount of the note will be *deferred*.

The payment of taxes on the portion of the profit allocated to the principal is automatically deferred from the time of the sale to each year as principal is paid on the note. [IRC §453]

Combining a carryback with a §1031

An investor correctly understands the sale of his property, including cash, a carryback note and debt relief, will not trigger profit reporting on the sale, if:

- the net proceeds from the sale (cash and note) are used to purchase replacement real estate, and the investor avoids actual or constructive receipt of the sales proceeds; and
- the replacement real estate is (or will be) encumbered by debt equal-or-greater in amount than the loan on the property being sold. [Revenue Regulations §§1.1031(d)-2; 1.1031(k)-1(f)]

Can the investor receive the carryback note on the sale and then combine the installment sale reporting of the note with a §1031 exemption for the rest of his profit by using the cash down payment to purchase replacement property in a **tandem tax avoidance plan**?

Yes! When the investor's cash proceeds from the sale of his property are properly disbursed to acquire §1031 property, and the carryback note is retained by the investor, installment sale reporting on that portion of the profit allocated to principal in the note is automatic — even though the sale is reported as a §1031 reinvestment of the cash down payment. [**Mitchell** v. **Commissioner** (1964) 42 TC 953]

Further, when a carryback note is received by an investor on a sale in which the cash proceeds from the sale are used to acquire replacement property, the §1031 reinvestment plan is reported as a *partial §1031*. In the partial §1031 transaction, the note carried back and retained by the investor is considered *cash boot*.

Again, the receipt of cash items prior to acquiring a replacement property cannot be later offset. Thus, a portion of the profit on the sale becomes reportable and taxed on the **cash items** received — the carryback note. [IRC §1031(b)]

However, the combined §453 and partial §1031 reinvestment raises an accounting question which affects the structuring of the carryback note:

Should the carryback note be structured as an all-inclusive trust deed (AITD) note to avoid profit reporting on the principal of the loan which exceeds the property's cost basis, the mortgage-over-basis situation?

Often, property is refinanced or further (equity) financed during ownership, or was acquired on a small down payment or in a §1031 reinvestment. As a result, the principal amount of the loan(s) on the property becomes greater than the cost basis. When a mortgage-over-basis financial condition exists on a cash-out sale of property, part of the profit taken on the sale is attributable to the principal amount of the debt relief and immediately taxed. While the debt relief can be offset in a §1031 reinvestment, the debt relief can be entirely avoided on a cash-out sale by retaining responsibility for periodic payments on the loans by use of an AITD.

No AITD with mortgage-over-basis

When a property sold has a mortgage-over-basis situation, and the net sales proceeds will not be reinvested in a §1031 replacement property, it is proper (and taxwise, always prudent) to use an AITD note to wrap the existing loan(s) on the property. An AITD is used in lieu of a standard carryback note. [**Professional Equities, Inc.** v. **Commissioner** (1987) 89 TC 165]

The AITD note always **maximizes the portion of the profit** on the sale which is allocated to the principal amount of the carryback in a mortgage-over-basis situation. With an AITD note, no debt relief occurs due to the loan wrap-around arrangements made for the existing loan on the property. Responsibility for making the periodic payments on the loan remains with the seller under an AITD.

However, in a §1031 reinvestment plan, the AITD note becomes a disadvantage when a mortgage-over-basis situation exists. An AITD carryback reduces the amount of tax-exempt profit carried forward to the replacement property, the opposite of the result desired in a §1031 reinvestment plan.

For example, a real estate investor agrees to sell property on terms which include:

- a cash down payment;
- the buyer's assumption of the existing loan; and
- a carryback note for the balance of his equity, called a *standard note*.

The principal balance of the loan encumbering the property is greater than the investor's remaining cost basis, and no §1031 reinvestment is involved.

Here, the profit the investor will be reporting is larger than the investor's net equity in the property, the result of the mortgage-over-basis condition. Thus, the profit exceeds the net sales proceeds (cash and carryback note). The investor is then taxed on an amount greater than his actual net sales proceeds.

However, had the existing loan been wrapped by a carryback AITD note instead of allowing the buyer to assume it, the AITD note (for the balance of the purchase price after the down payment) increases the dollar amount of the investor's net sales proceeds. The sales proceeds now equals the entire sales price, not just his equity in the property. Thus, the sales proceeds (cash and AITD note) are now greater than the profit, and the profit taxable at the time the investor receives his cash proceeds is hugely reduced.

As a result, the portion of the profit allocated to the principal in the AITD note is far larger than had a standard carryback note been used to structure the installment sale. The investor does not then pay taxes on an amount of profit that exceeds the cash he actually receives.

However, the tax results are quite different for an installment sale when it is coupled with a §1031 reinvestment plan. In a §1031 transaction, the entire amount of the cash down payment used to buy replacement real estate is treated as tax-exempt profit. Thus, the cash reinvested is deducted from the profit on the sale the profit remaining is allocated to the principal in the carryback note to be taxed in future years.

Further, and more importantly, all the profit not allocated to the principal in the carryback note is carried forward to the replacement property untaxed. With the use of a standard note, a smaller amount of profit will be taxed as an installment sale than had an AITD note been used.

In contrast to the use of a standard note in a mortgage-over-basis situation, an AITD note carried back by the seller in a §1031 reinvestment plan **decreases the amount of profit** from the sale that is exempt from taxes under §1031. The AITD increases the amount of taxable profit reported as part of the installment sale when the loans exceed the property's basis.

Allocating profit to the carryback note

On any sale or exchange of real estate, the investor **takes a profit** when the sales price exceeds the investor's remaining cost basis in the property sold. When an installment sale is coupled with a §1031 reinvestment of the downpayment cash, the question becomes: How much of the profit taken on the sale must the investor report as a *recognized gain* that is taxed, and, if so, when does he report the recognized gain and pay taxes?

For example, in a **fully qualified** §1031 reinvestment plan, the basis in the property sold, along with the entire profit on a sale, is carried forward to the replacement real estate. However, not all the profit is carried forward with the basis in a **partial §1031**. Some capital is withdrawn by the investor on the sale in the form of *cash items*, such as a carryback note. On the withdrawal of capital, profit taken on the sale is allocated to the principal amount withdrawn, and taxed. [IRC §1031(b)]

Capital is **withdrawn** in a §1031 reinvestment plan:

- in the form of cash or principal in a carryback note received on the sale of the property sold, or by the receipt of unqualified property in the exchange, called *cash items* or *cash boot*; or
- by assuming a lesser amount of debt on the purchase of the replacement property than the amount of the debts encumbering the property sold (and not otherwise offset by cash item contributions), called *net debt relief* or *mortgage boot*.

In an installment sale, for example, an investor receives a carryback note for a portion of his sales price. In a §1031 reinvestment, the investor uses the cash down payment to purchase replacement property.

When the cash down payment is reinvested to purchase replacement property, the **allocation of profit** from the sale to the principal amount of the carryback note is a three-step analysis:

1. Calculate the profit in the price received by the investor on the sale or exchange (net sales price minus basis equals profit). [See **first tuesday** Form 354 §3.13]
2. Deduct from the profit the cash down payment the investor used to purchase replacement property, sometimes called *§1031 money*.

3. Allocate a portion (or all) of the remaining profit to the principal in the carryback note, limited to the total principal in the note. [IRC §453(f)(6)(A); Rev. Regs. §15A.453-1(b)(2)(iii)]
4. Any profit then remaining is implicitly carried forward with the basis to the §1031 replacement property as *tax exempt*. [See Figure 2]

The **profit allocated** to the principal in the carryback note will not be taxed at the time of the sale, but the profit will be reported and taxed annually as principal is paid on the carryback note.

Calculating profit in a §453 and §1031 sale

To apply the rules for the **allocation of profit** to the carryback note, consider an investor who sells real estate for $1,000,000.

The investor's basis in the property sold is $400,000 and the existing encumbrance on the property is $300,000, a *basis-over-mortgage* situation.

The buyer will purchase the property on terms which include:

- a cash down payment of $200,000, which the investor will use to purchase replacement property;
- assuming the existing $300,000 loan; and
- executing a carryback note payable to the investor for $500,000.

The investor's profit on the sale is $600,000 ($1,000,000 price minus the $400,000 basis). The $200,000 cash down payment the investor uses (as §1031 money) to purchase replacement property is first deducted from the profit, leaving a $400,000 profit to be next allocated to the principal amount of the carryback note.

The entire $400,000 profit remaining is allocated to the principal in the carryback note since the profit remaining after deducting the §1031 money is less than the amount of the carryback note. Here, an AITD note would have produced the same maximum §1031 tax exemption results, and will always do so in a *basis-over-mortgage* situation. (However, the §453 installment sales tax result on a cash-out sale that uses an AITD note will be quite different, as reviewed earlier in this chapter.)

Thus, 80% of each **principal payment** will be reported annually as profit received on the carryback note ($400,000 profit remaining divided by the $500,000 carryback note). The other 20% of all principal payments represents a tax-free return of originally invested capital. [See Figure 1]

Now consider the same $1,000,000 property with its $400,000 basis. But unlike the prior example, it is encumbered with a larger loan amount of $600,000 — a *mortgage-over-basis* situation.

With a $1,000,000 selling price and a $200,000 cash down payment, the investor will carry back a note in the principal amount of $200,000 for the remaining balance of his $400,000 equity.

As in the prior example, the entire profit on the sale is $600,000. Again, the $200,000 cash down payment reinvested to purchase §1031 replacement property is deducted from the $600,000 profit, leaving a $400,000 profit to be next allocated to the principal in the carryback note.

However, unlike the prior example, the profit remaining after deducting the §1031 money is greater than the principal in the $200,000 carryback note due to the mortgage-over-basis situation. Thus, only $200,000 of the profit is the portion allocated to the principal in the note, the **allocation being limited** to the principal amount of the note.

Tax analysis on the property sold in a combined §453/§1031

Figure 1 — Basis exceeds mortgage

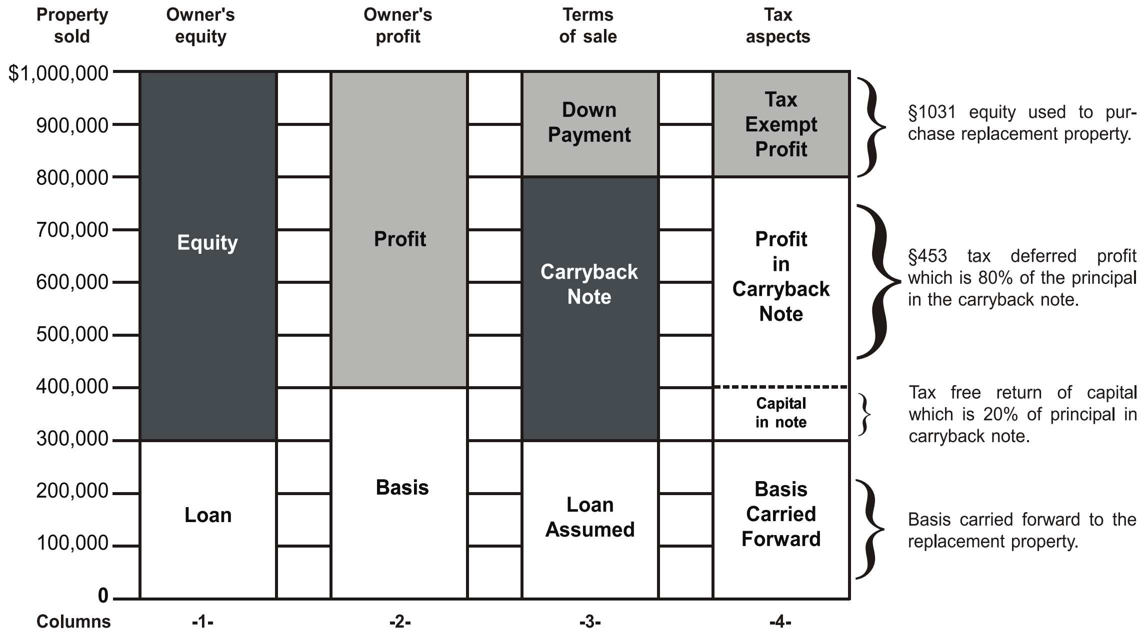
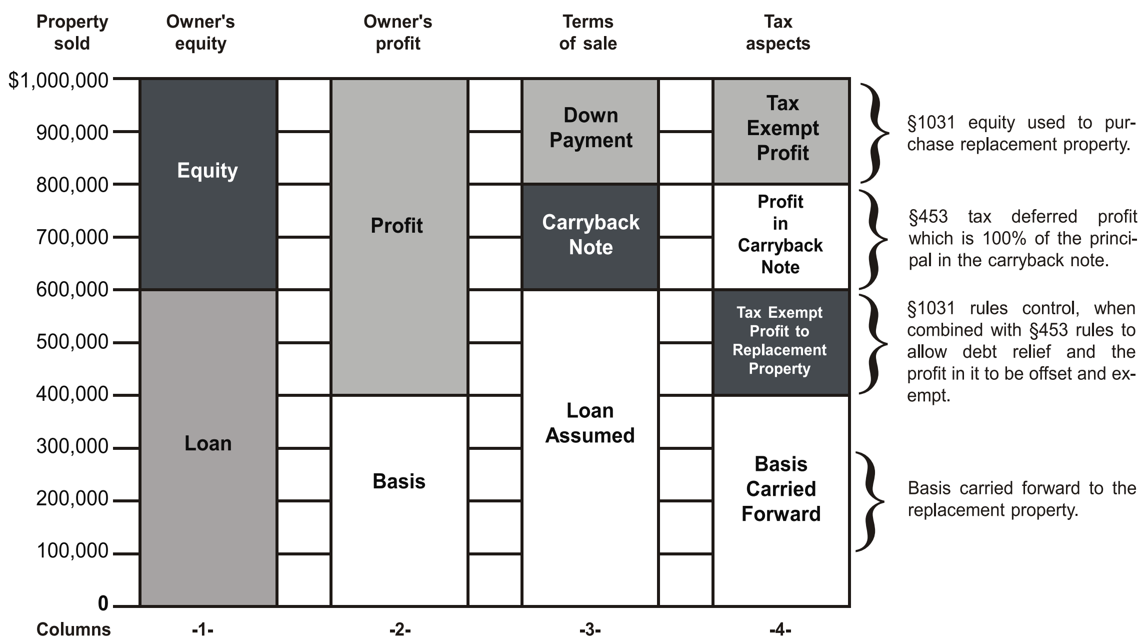


Figure 2 — Mortgage exceeds basis



Each column represents a separate set of facts, each column having the $1,000,000 sales price as its common factor. The tax exempt profit in Column 4 is tax exempt only if the loan assumed by the buyer in Column 3 (debt relief) is offset by the owner's assumption of equal or greater debt or the contribution of cash items to purchase the replacement property.

Here, the $200,000 balance of the profit remaining after allocation to the carryback note will not be taxed, as it is implicitly carried forward with the cost basis to the replacement property.

Thus, the entire principal amount (100%) of the carryback note will be reported as profit. The existing loan(s) on the property sold exceeded the investor's basis. [See Figure 2, *ante*]

Had the carryback in this mortgage-over-basis example (but not the prior basis-over-mortgage situation) been an $800,000 AITD note for the balance of the purchase price after the cash down payment, the amount of the principal in the AITD note would then exceed the profit remaining after first deducting the §1031 money from the profit. As a result, the entire $400,000 remaining profit would have been allocated to the principal in the carryback AITD note and taxed.

Chapter 44 The principal residence profit exclusion

This chapter presents the tax scheme and qualifications for avoiding the taxation of profit taken on the sale of a principal residence.

Tax-free sale up to $250,000 per person

On the sale of a homeowner's residence, up to $250,000 in **profit** per owner-occupant qualifies to be excluded from income and is not taxed. Thus, some or all of the increased value of a principal residence over the owner's purchase price and cost of additional improvements is received tax-free on a sale or exchange of the residence, subject to several conditions which most homeowners meet when they sell. [Internal Revenue Code §121]

A broker advising a homeowner on the **timing of a sale** of the owner's residence to achieve the maximum profit exclusion from taxation must consider the *qualifying conditions*, including:

1. Does the property qualify as the seller's **principal residence**? [IRC §121(a)]

2. Do the seller, the spouse, and other co-owner each qualify as **owner and occupant** for periods totaling two years during the five years preceding the close of the sale? [IRC §121(a)]

3. If only one spouse is the vested owner, did the **non-vested spouse** also occupy the property as a principal residence for periods totaling two years during the five years prior to closing? Also, the non-vested spouse must not have taken a profit exclusion on the sale of a principal residence within two years prior to closing. The non-vested spouse then qualifies the couple for an additional $250,000 exclusion (the total now being $500,000) by filing a joint return. [IRC §121(b)(2), (d)(1)]

4. Did the homeowner **disqualify himself** by taking the profit exclusion on the sale of a different principal residence within two years before closing? [IRC §121(b)(3)]

5. If sold prior to completing two full years of ownership and occupancy, or within two years after closing a sale on a prior principal residence and taking a profit exclusion, does the sale qualify for a **pro rata amount** of the $250,000 exclusion as a result of *qualifying unforeseen difficulties*? [IRC §121(c)(1), (2)]

6. Did the homeowner take any **depreciation deductions** for a home office or rental of the property after May 6, 1997 which must be reported as unrecaptured gain (25% tax)? [IRC §121(d)(6)]

7. If the seller is an unmarried surviving spouse who has not owned and occupied the property for the two-year period, will he or she qualify by **tacking** the deceased spouse's period of ownership and occupancy? [IRC §121(d)(2)]

8.If the owner is in a government-licensed facility, being physically or mentally incapable of taking care of himself, and previously resided on the property for periods totaling at least one year

during the past five years, does **tacking** the time spent in the facility while owning the property qualify the owner for the two-year ownership and occupancy requirements, and thus the $250,000 exclusion? [IRC §121(d)(7)]

9. Is the seller the estate of a **deceased homeowner** or a person who inherited the property by will or living trust, and if so, did the deceased homeowner die after December 31, 2009 and own and occupy the property for a two-year period during the five years prior to the sale of the property? [IRC §§121(a), 1022]

The principal residence or second residence

Occasionally, a couple will have two or three residences that they occupy at different times during the year (a summer residence on the lake, a desert retreat, a residence in a prestigious community, etc.). On the sale of one of the residences at a profit, the question arises as to which home is the *principal residence*.

Identifying one of two or more residences as the principal residence is based initially on whether the owner seeking the $250,000 per person profit exclusion uses the property a *majority of the time* during the year.

Other factors taken into consideration when two or more residences exist is whether the claimed principal residence is located near the owner's employment, is used as the address listed on state and federal tax returns and is relatively close to banks and professional services used by the owner.

A sale also includes a principal residence subject to an involuntary conversion, such as destruction, theft, seizure, requisition or condemnation. Thus, all the rules for an exclusion of $250,000 would apply. [IRC §121(d)(5)]

For a **married couple**, the maximum possible exclusion of profit from taxation is $500,000, if both qualify. [IRC §121(b)(2)]

The right to an exclusion on a particular sale is lost by the individual who has taken the exclusion on the **sale of another** principal residence which closed within two years prior to closing the sale of the current principal residence.

Profit exclusion for single individuals and co-owners

The amount of profit (or loss) taken on a sale of real estate is set by subtracting the seller's cost basis in the property from the net sales price he receives — a formula of "price minus basis equals profit."

Profit taken by an individual on the sale of his principal residence may qualify for the $250,000 profit exclusion. To qualify, an individual must **own and occupy** the residence sold for at least two of the five years prior to closing the sale. [IRC §121(a),(b)(1)]

Thus, each **individual** who owns a principal residence, in whole or in part, and has occupied it for periods totaling two of the five years before closing the sale, can exclude up to $250,000 from his share of the profit on the sale of the property.

Consider an individual who occupies a property as his principal residence for one year. He then moves out, but retains ownership and rents the property.

More than four years after vacating the property, the individual reoccupies the property as his principal residence for one year before closing a sale of the residence at a profit.

Here, the individual occupied the property he owned as his principal residence for a total of two years. However, the individual did not occupy the property for a total of two years within the five-year period immediately preceding the sale, a requisite to excluding the profit from taxes. Thus, he cannot use the $250,000 exclusion to avoid taxes on the profit from the sale of the property. [IRC §121(a)]

Principal residence exclusion for married couples

A married couple who owns and occupies a property as their principal residence for at least two of the five years prior to the sale can, if not disqualified, exclude an aggregate amount of up to $500,000 in profit taken on the sale — $250,000 per person. [IRC §121(b)(2)]

For a husband and wife to qualify for the **combined $500,000** profit exclusion on the sale of a principal residence:

- either may **solely own** the residence as separate property, or both may be co-owners, since ownership by one spouse alone is imputed to the non-owner spouse;
- **both must occupy** the property during the ownership for time periods totaling two years or more within the five years prior to the sale;
- the couple must file a **joint return** as a married couple for the year of sale; and
- **neither** spouse may have taken the $250,000 profit exclusion on another principal residence within two years prior to the sale. [IRC §121(b)(2)]

However, should either spouse be **disqualified** for having taken the principal residence profit exclusion on the sale of another residence which closed within two years prior to closing the sale of the current residence, the other spouse, owner or non-owner, qualifies for an individual $250,000 profit exclusion on their joint return. [IRC §121(b)(2)(B)]

Consider a husband who is the **sole owner** of a residence that is his separate property. The husband and his wife **both occupy** the property as their principal residence during his ownership. They do so for more than a total of two years during the five years immediately preceding the sale of the property.

Neither spouse has sold a principal residence nor taken a $250,000 exclusion on any sale during the two-year period prior to closing. The couple files a joint return for the year of sale.

Here, the couple qualifies to exclude up to $500,000 of profit taken on the sale of the residence, even though one spouse has no ownership interest in the real estate.

Now consider a husband and wife who each owned and occupied separate principal residences prior to their marriage. The wife sold her prior residence after getting married.

During the five years prior to the closing of the sale, the wife occupied her property as her principal residence for time periods totaling at least two years. For the year of the sale of the wife's residence, the husband and wife file a joint return.

Can the couple take a $500,000 profit exclusion since the property was sold during the marriage?

No! Only a $250,000 exclusion from profit is allowed. The husband does not qualify for an additional $250,000 profit exclusion since he did not also occupy (for two years) the residence his wife owned and sold.

Both spouses must occupy the residence for a period totaling two years for each to qualify for a $250,000 profit exclusion, whether one spouse or both own the property.

No marital taint to disqualify

Again consider a couple who individually own properties which each occupies as their individual principal residence for two consecutive years prior to their marriage.

On marriage, the husband and wife both relocate to a newly-acquired residence. Each spouse needs to sell their prior residences.

The husband sells his prior residence at a profit. The couple files a joint return for the year of the sale.

Here, only the husband qualifies and may take the $250,000 profit exclusion on the couple's joint tax return. The wife did not also occupy the property he sold as her principal residence for two of the five years prior to the sale of the property.

Within two years after the husband closes the sale on his prior residence, the wife closes the sale of her prior residence at a profit. The wife, having owned and occupied her residence for two of the past five years, qualifies for a $250,000 profit exclusion. The husband and wife file a joint return for the year the wife sold her residence and claim the wife's $250,000 profit exclusion.

Here, the wife is qualified to take the individual $250,000 profit exclusion — even if the husband sold and took a $250,000 profit exclusion within two years of her sale. [IRC §121(b)(3)(A)]

In contrast, consider a man who, either prior to or after getting married, closes escrow on the sale of his principal residence and takes a profit.

The man owned and occupied the principal residence for time periods totaling more than two years during the five years prior to closing the sale. A $250,000 profit exclusion is taken on the sale.

Since their marriage, both the man and his wife have occupied as their principal residence the wife's separate property for periods totaling at least two years within the past five years.

Less than two years after the husband closed the sale on which he took the $250,000 profit exclusion, the residence owned by his wife is sold and escrow closed.

Can the couple file a joint return and qualify for the $500,000 profit exclusion by reason of their marriage, the wife's separate ownership and their shared occupancy of the residence?

No! Only the wife qualifies for a $250,000 profit exclusion on their joint return.

Even though the husband met the (imputed) ownership and (actual) occupancy requirements for the property sold by his wife, the husband took a $250,000 profit exclusion on the sale of his prior principal residence which closed within the two-year period immediately before the closing of the sale of the wife's residence. Thus, the couple does not qualify for the total $500,000 profit exclusion. [IRC §121(b)(3)(A)]

Similarly, had the second residence sold been community property and not separately owned by the wife, only the wife would have been allowed to take a $250,000 profit exclusion on their joint return.

Closing the sale of the residence they both occupied should have been delayed to a date more than two years after the sale closed on the husband's residence. If closing the sale had been delayed, the couple,

one owning and both occupying for the required two-year period, would have qualified for the combined $500,000 profit exclusion.

Unoccupied at time of sale

An individual or married couple **need not occupy** a property as a principal residence when the property is purchased or at the time of the sale to qualify for the $250,000 or combined $500,000 profit exclusion.

Consider a married couple who acquires a property and occupies it continuously as their principal residence for over two years.

Later, the couple buys another property and moves in, occupying it as their principal residence. The couple rents the old residence to a tenant, converting it into a depreciable income property.

Within three years after moving out of their prior residence, the couple closes a sale on the prior residence and takes a profit. The couple files a joint tax return for the year of the sale.

Here, the couple may properly take a $500,000 profit exclusion on the sale. The couple **owned and occupied** the prior residence as their principal residence for at least two of the last five years and neither was disqualified by having taken a $250,000 profit exclusion for the sale of a prior principal residence which closed within the two-year period preceding the current sale.

An orderly liquidation

Now consider a married couple who has occupied their principal residence for over two years. They also own, either separately or as community property, several single-family residential rental properties.

The couple sells their principal residence and takes a profit of $300,000 on the sale. They file a joint tax return for the year of the sale and take the $500,000 profit exclusion — avoiding any tax on the $300,000 profit.

The couple then moves into one of the residential rental units they co-own, converting its use to their principal residence.

Two years after occupying the residential rental unit as their *principal residence*, the couple sells the unit and takes a profit. The couple files a joint tax return for the year of sale and uses the $500,000 profit exclusion to avoid taxes on the profit.

They then move into another rental unit owned by one of them separately, also converting its use to their principal residence. The unit they move into will be sold after two years of their occupancy.

Again the couple will use the $500,000 profit exclusion to shelter any profit taken on the sale from taxes.

Thus, by repeating the two-year occupancy of single-family residences they own as their principal residence, the couple is able to:

- liquidate their real estate holdings; and
- avoid paying tax on the profit taken on the sales.

Should the couple **carry back** a note and trust deed on the sale of one of the properties, the profit allocated to the principal in the note will be declared in the year of sale and excluded from taxation as part of the $500,000 exclusion of profit on the sale. [IRC §453]

Unforeseen difficulties

Even if an individual or couple **cannot fully meet** the two-year ownership and occupancy requirements, they may still qualify to exclude all of their profit. The amount of their exclusion is a *prorated portion* of the $250,000 profit exclusion available to each person who qualifies on the sale of a principal residence. The proration for setting the available amount of exclusion is based on the portion of the two years they did occupy prior to the sale.

To qualify for proration of the $250,000, an *unforeseen difficulty* must arise and cause the property to be sold, which includes:

- a **change in employment**, based on factors of concurrent occupancy of the residence at the time of the job relocation, and the financial need to relocate for the employment;
- a **change in health**, such as advanced age-related infirmities, severe allergies or emotional problems; or
- **unforeseen circumstances**, such as natural or man-made disasters, death and divorce. [IRC §121(c)(2); Temporary Revenue Regulations §1.121-3T]

Thus, a change in location of the job workplace may qualify the homeowner for a *reduced maximum exclusion* of less than $250,000 profit on the sale of his principal residence without first owning and occupying it for the full two-year period.

Employment compelling the homeowner to relocate can be based on a required job relocation by his current employer, the commencement of employment with a new employer, or if the homeowner is self-employed, the relocation of the place of business or the commencement of a new business.

For the sale to qualify for a reduced amount of the total profit exclusion, the **primary reason** for the sale must be a *change in the place of employment*. Factors used to determine whether the primary reason for the sale is a change in the place of employment include:

- the need to relocate must arise during the occupancy of the residence sold;
- the sale of the principal residence and the homeowner's need to relocate are close in time;
- the need to relocate was not foreseeable by the homeowner when he acquired and first occupied the principal residence sold;
- the principal residence is no longer suitable as the principal residence because of the place of employment;
- the homeowner's financial ability to carry the residence requires the residence be sold.

Some sales due to relocation to a new place of employment are "deemed" to be a change without concern for the factors supporting a primary reason, such as:

- if employed, the new job location is more than 50 miles farther than the old job was from the principal residence that was sold; or
- if unemployed, the job location is at least 50 miles from the residence sold.

Thus, when a homeowner must sell because of *unforeseen difficulties*, profit is excluded from taxation up to an amount equal to the pro rata amount of the $250,000 per person exclusion based on that portion

of the two years the owner actually owned and occupied the property as his principal residence. [IRC §121(c)(1)]

For example, a homeowner is forced by his employment to relocate out of the area.

The homeowner has owned and occupied his principal residence for one year and six months — 75% of the necessary two-year occupancy period.

The homeowner sells his residence, taking a $40,000 profit.

When filing his tax return, the homeowner will be able to exclude the entire $40,000 since the entire profit is less than 75% of the $250,000 exclusion. The same ratio would apply to a couple's $500,000 profit exclusion under the same circumstances. [IRC §121(c)]

Chapter 45 — Deduction of points by homebuyers

This chapter discusses the income tax deductions a homebuyer or homeowner may take for the loan points and origination fees incurred on a refinance, purchase-assist or improvement loan.

Prepaid interest write-off exception

Interest on a loan **accrues daily** over the life of the loan. In contrast, a lender's penalty charge (bonus) accrues in its entirety on the occurrence or failure of an event, as with a late charge or prepayment penalty.

Taxwise, **interest**, no matter the form it may take, which has accrued and been paid on a loan can be written off when determining income tax liability if the interest qualifies as either an *expense or deduction from income*.

For example, *accrued interest paid* on a loan, the proceeds of which funded a person's **trade or business activities**, is written off as an *operating expense* of the person's business.

Conversely, **accrued interest paid** on a loan that funded the purchase, improvement or carrying costs of a **rental property** is not an **operating expense** incurred by the property. Thus, mortgage debt on a rental property is not considered when establishing the property's net operating income (NOI). However, interest is written off as a **deduction** from the NOI produced by the rental property (which is also the depreciation allowance). [See **first tuesday** Form 352]

Somewhat different from accounting for interest on a business or rental property, accrued interest paid on a loan that funded the purchase, improvement or carrying costs of **portfolio property** held for long-term profit (such as ground leases, management-free, triple-net leases or land held for profit on resale), is written off as a **deduction** against any income and profit from all sources within the portfolio income category.

Then, the income or loss within each of the three different income categories is calculated independent of each other category. As a result, the reportable income or loss within one category is not commingled with income from any other category.

In contrast to loans for business, rental or portfolio purposes, home loans are treated differently. A loan that funds the purchase or improvement of an owner's **principal residence** or **second home** is a *personal use loan*. Accrued interest paid on personal use loans is not tax deductible, with some exceptions. One exception to the non-deductibility rule is interest paid on loans **with a connection to** the principal and second residence beyond providing security for payment of the loan.

Under the **non-deductibility exception**, interest accrued and paid on the first and second home loans is written off as a deduction once the owner's adjusted gross income (AGI) has been set. Thus, the home loan interest becomes part of the schedule A *itemized deductions* which directly reduce the homeowner's taxable income, not his adjusted gross income. Thus, the amount on which he will pay taxes is reduced.

Editor's note — The greater an individual's AGI, the smaller the total amount of allowable deductions. Itemized deductions on schedule A are phased out for the year as the AGI increases. Eventually, only as little as 20% of the total itemized deductions remains, which includes home loan interest.

The phaseout for 2006 begins for a married couple filing a joint return at a threshold of $150,500 in annual gross income. Thus, the total amount of the itemized deductions is reduced by 3% of every dollar the owner reports in AGI over the threshold. For example, if the itemized interest paid is $25,000 and the AGI (in 2006) exceeds $150,500 by $100,000, $3,000 of the $25,000 will be disallowed.

The government *subsidizes* homeownership through interest deductions on home loans which reduces the taxes the homeowner is required to pay. The amount of tax savings range from 10% and 15% for low-income homeowners, to 35% for high-income homeowners on the amount of interest they pay. Thus, the wealthier one is, to a point, the greater the subsidy for homeownership. Limitations on wealthier homeowners are imposed by the itemized deductions phase out and the alternative minimum tax (AMT) restrictions on allowable deductions.

Wealthier homeowners who are subject to the AMT and have encumbered their first or second home with an equity loan or refinancing (and have used the net proceeds for purposes other than the improvement of, or in connection with, the first or second home) are not allowed to deduct the interest paid on these loan amounts which are not connected to the purchase or improvement of the first and second home. [Internal Revenue Code §56(e)(1)]

The sole basis for allowing the personal interest deduction for a mortgage on a first and second residence is the **federal policy** of encouraging homeownership. The social policy is propagandized by the use of the slogan “The American Dream” and implemented through tax incentives and implicit guarantees for loans held by federally chartered lenders such as Freddie Mac or Ginnie Mae. The reasons behind the federal policy are that homeowners generally require less government assistance in their elder years and make more responsible local citizens.

Home ownership through tax incentives

Income tax law is often used by the federal government for *social engineering*. The social purpose for allowing immediate deduction of points is to **encourage tenants** to purchase homes.

However, a tenant compares the amount of his rent payment with the amount of his potential house payment when deciding to take on the status of homeowner (or vice-versa as a tenant). The house payment for new homeowners is typically greater than rent in California. Thus, the encouragement had little effect in California until after 2000, due to 125% negative amortization option-ARM loans with monthly payments for two to five years based on a 30-year amortization at the teaser rate of 1% to 3% interest.

While the deduction of loan origination points provides some financial aid during the new homeowner's first year of ownership, the homeowner's tax relief in the following years is limited to the interest included in the monthly payments and property taxes they paid.

However, the deduction of points in the year of purchase is more effective in inducing sustainable long-term home ownership than other tax incentives. The deduction of points is not a direct subsidy designed to bail out builders and REO lenders, as is a tax credit for buying a newly constructed home. Tax credits often encourage financially unprepared buyers to purchase homes, shifting the risk of ownership from overextended lenders and builders to homeowners (and last occured in 1975).

The points of interest

Points paid to a lender to originate a loan are considered *prepaid interest* since points are interest, and the interest has not yet accrued. Points essentially buy down the loan's *par rate* for the life of the loan to the interest rate denominated in the note. No points means a higher *nominal interest rate* will be stated in the note.

As **prepaid interest**, only the fraction of the points paid which accrues each month over the life of the loan, called the *life-of-loan accrual*, may be deducted against that year's income, with exceptions. When the loan amount is fully prepaid, any remaining unaccrued prepaid interest can then be deducted.

As an exception to the **life-of-loan** accrued reporting, the entire amount of the points paid on loans that assist in the purchase or improvement of an individual's **principal residence** (not a second home) is allowed as a *personal deduction* in the year the loan originated. The immediate deduction for all points paid in connection with a loan that finances the purchase or improvement of the taxpayer's primary home is another government subsidy, part of the overall policy to encourage homeownership in lieu of renting.

The points deduction exception for a principal residence does not include points paid on loans secured by second homes or vacation residences. [IRC §461(g)(2)]

Further, the deductibility of the loan points in the year paid, instead of over the life of the loan, depends on **who paid the points** — the buyer, the seller or the lender.

For example, a homebuyer applies for a loan to fund the purchase of property he will occupy as his principal residence. The loan will be secured by the residence. The lender will be paid points (prepaid interest) for making a purchase-assist loan at an interest rate below the **par rate** for the loan. The lender will not withhold the points from the loan proceeds (as a discount) or add them to the loan balance.

The points will be paid by either the homebuyer from his separate funds, or by the seller, under the terms negotiated by the buyer and his agent in the purchase agreement.

In this situation, the homebuyer can write off the points paid to the lender as a **current deduction** from his adjusted gross income (AGI), since:

- the loan proceeds are used to **purchase or improve** the borrower's principal residence;
- the loan is **secured** by the principal residence, with or without any additional security;
- the Uniform Settlement Statement (USS) accounts for the points paid as "points," "loan origination fees," "loan discount" or "discount points", and compute them as a percentage of the loan;
- the points were paid by the seller or from the buyer's separate funds, not as a discount or add-on by the lender;
- the payment of points is an established business practice of lenders in the area; and
- the points paid do not exceed the amount of points generally charged in the surrounding area. [Revenue Procedure 92-12]

Deductible points

To deduct the points in the year they are paid, the purchase-assist or improvement loan must be **secured by** a buyer's or homeowner's principal residence.

When the loan is secured solely by property other than the residence purchased or improved with the loan funds, such as business or rental property owned by the homeowner or others, the points must be deducted over the life of the loan. [IRC §163(h)(3)(B)(I)]

Likewise, points paid by a buyer to finance the purchase or improvement loan for a **second residence** must be deducted as they accrue over the life of the loan. For example, points paid on a purchase-assist loan for a vacation home, payable monthly with a 30-year amortization, will be deductible 1/360th for each month of the tax year as the prepaid interest accrues.

Now consider the homeowner who obtains a home improvement loan secured by his **principal residence**.

The homeowner pays 2½ points on the loan from his separate funds. One of the points is called a *loan origination fee* and is a competitive amount.

Here, the points, even when they are called loan origination fees, are considered prepaid interest. An origination fee is fully deductible if the fee is **based on a percentage** of the homeowner's loan amount.

The owner also pays loan charges itemized by the lender to include administrative fees, processing fees, appraisal fees, title expenses and mortgage insurance premiums (MIPs).

Can the owner also deduct these itemized lender charges in the year they are paid?

No! These itemized charges reimburse the lender for **costs incurred** to originate the loan. Lender costs reimbursed by the borrower are not considered prepaid interest and are not deductible either at the time paid or over the life of the loan. [IRC §163; Rev. Proc. 94-27]

Loan costs incurred by the lender and paid by the owner on any type of real estate to originate a purchase or improvement loan are *capitalized* by the owner. Thus, loan costs are added to, and become part of, the owner's **cost basis** in the property and are not deducted or expensed as interest. Loan charges are non-recurring costs incurred to acquire or improve property, not daily recurring interest which can be expensed or deducted as it accrues and is paid or was prepaid. [**Lovejoy** v. **Commissioner of Internal Revenue Service** (1930) 18 BTA 1179]

Capitalized costs for originating a loan on property other than the first and second home are partly recovered by annual depreciation deductions, and fully recovered when the property is sold.

Seller-paid points

Consider a homebuyer who lacks sufficient funds or incentive to pay the points required to originate a home loan. During the buyer's negotiations with a seller, and as a provision in his offer to purchase the property, the seller agrees to pay the points so he can sell the property to the buyer.

In this instance, the homebuyer is allowed to deduct the points paid by the seller to assist the buyer in originating a purchase-assist loan. When the **seller pays the points**, the homebuyer is considered to have received **cash back** from the seller in the amount of the points. The cash is then used to pay the points as though the cash had come from the buyer's *separate funds*. [Rev. Proc. 94-27]

However, when the seller pays the points and the buyer deducts the amount as prepaid interest, the buyer's *cost basis* in the residence must be adjusted to reflect a **reduction in the price paid** by the dollar amount of the seller-paid points. The seller who paid the points expenses the amount as part of his costs of the sale, not as interest paid by the buyer's use of the cash. This tax treatment for the seller makes a

financial difference if he is selling his principal residence at a loss since if it is interest he can deduct it and if it is cost of a sale he cannot take a loss.

Lender-paid points

Consider a homebuyer who lacks sufficient funds to pay the points demanded by a lender for the interest rate sought on a 30-year purchase-assist loan. Additionally, the seller refuses to pay any of the points without first renegotiating the purchase price of the property.

The lender agrees to increase the loan amount and withhold the points from the loan proceeds as a **discount**.

Can the homebuyer deduct the points paid from the loan proceeds in the year the points are paid?

No! The homebuyer did not pay the points from separate funds, either his own or funds he received from the seller. The points were paid as a discount, or an add-on, to the loan. The points, being prepaid interest withheld by the lender, must be deducted annually as they accrue over the 360-month life of the 30-year loan.

Deduction of points on refinancing

Consider a homeowner who refinances the existing purchase-assistor improvement loan on his principal residence and pays the points for the refinancing from his separate funds.

Here, the **refinancing** did not fund the purchase or improvement of the residence, even though it funded the payoff of a purchase or improvement loan. Thus, the points on a refinance are annually written off as they accrue monthly over the life of the loan.

However, if a homeowner uses the **excess loan proceeds** from refinancing to make home improvements, a pro rata share of points paid from the homeowner's separate funds (equal to the percentage of the loan funds which paid for improvements) can be deducted in the year the homeowner refinanced his personal residence. [Revenue Ruling 87-22]

When the homeowner sells his residence or refinances again, the unaccrued points remaining on the existing loan are reported (with itemized deductions) as interest paid in the year of the sale, whether the loan is paid off or assumed by a buyer.

Consider a different homeowner who refinances his principal residence to reduce his monthly payment by $500. The monthly savings are then spent on home improvements, such as a roof replacement and remodeling of the kitchen and bathrooms.

The homeowner deducts all the points he paid for refinancing in the year he refinanced as an itemized deduction on his federal income tax return. He claims the refinancing freed up money for the improvements and was thus a property improvement loan.

The Internal Revenue Service (IRS) disallowed the deduction, claiming the refinancing merely funded the payoff of an existing loan on the property with no net loan proceeds for any improvements.

In this scenario, the deduction of all the points paid to refinance the existing loan is permitted. The refinancing was a loan the homeowner incurred **in connection with the improvement** of the property. The reduction in payments caused the homeowner to have funds to pay for the improvements he then made on the property. [Tax Court Summary Opinion 2005-125 (non-precedent)]

Refinancing short-term financing

A homebuyer executes a short-term note with a three-year balloon payment to help finance the purchase of his principal residence. The short-term note, which is secured by the residence, is a sort of swing loan which must be refinanced if the buyer is to continue his ownership of the residence as intended.

When the note becomes due, the homebuyer obtains permanent long-term financing. The short-term note is paid off with the proceeds of the permanent financing.

The homebuyer deducts the entire amount of the points paid on the long-term refinancing in the year paid. He claims the permanent financing was part of his original scheme to finance the long-term ownership of his principal residence, and was not mere refinancing.

The Internal Revenue Service (IRS) claims the homebuyer cannot deduct the points paid on the permanent financing since, to be entitled to an immediate deduction as a loan made in **connection with the acquisition** of the principal residence, the points must be paid on a loan made to directly fund the actual purchase or improvement of the principal residence.

Here, the points paid on the long-term refinancing of a short-term balloon payment note are deductible in their entirety in the year the points are paid. The existence of a **short-term due date** in the note originated as a purchase-assist loan was evidence that the homebuyer contemplated refinancing the short-term note to retain the residence for long-term ownership. [**Huntsman** v. **Commissioner of Internal Revenue** (8th Cir. 1990) 905 F2d 1182]

The long-term loan, while it did not directly fund the purchase of the residence, was obtained **in connection with the purchase** of the residence. The refinancing occurred within the original term of the short-term balloon payment note, which by its nature compelled the refinancing.

Any indebtedness incurred in connection with the purchase or improvement of the homeowner's principal residence qualifies the points incurred to originate the loan for immediate deduction in the year paid. [IRC §461(g)(2)]

Chapter 46 Short payoffs on recourse and nonrecourse loans

This chapter sets forth the income and profit reporting on the sale of real estate when the value falls below the outstanding balance on loans encumbering the property.

Discount reported as income or as a cost reduction

An owner purchased his personal residence for $250,000. The owner made a down payment of $50,000. The remaining $200,000 of the purchase price was funded by conventional financing.

Taxwise, the owner's cost basis in the real estate is $250,000, plus transactional costs. The owner's basis will set the profit or loss on the *price realized* when a resale or other disposition of the residence, such as foreclosure or deed-in-lieu, later occurs.

The *cost basis* on acquisition is:

- the total value of all contributions made by the buyer to the down payment on the price;
- any debt originated or taken over by the buyer which finances the acquisition of the property; and
- closing costs, called *transactional costs*.

The property was purchased at the peak of the previous real estate boom in prices. Due to a decline in real estate values since then, the owner's personal residence is currently worth $150,000. While the owner's monthly payments have remained the same, the owner's income has also declined. All of the owner's disposable income is now consumed by payments on the loan. The owner can no longer afford to continue to make loan payments.

The loan balance is $194,804.44, an amount far in excess of the value of the real estate.

The owner lists the real estate with a broker in an attempt to sell it and get out from under the excess debt, *subject to* the lender's approval.

The broker, realizing the fair market value of the real estate is far below the outstanding debt encumbering the property, must, as part of his sales effort, negotiate with the lender for a discount on a loan payoff demand, called a short payoff. If the lender agrees to accept a short payoff, the property will have gone through a "short sale" process.

The short sale and discount

A **short sale** is a transaction in which the lender accepts as a final payoff the seller's net proceeds from the sale of his property, an amount that is less than the outstanding balance on the loan.

The difference between the principal balance on the loan and the lesser amount of the net proceeds from the short sale is a *discount*.

If the broker is unable to negotiate a **short payoff** — discount — with the lender, the seller will stop making payments and the lender will be forced to foreclose for failure of a *pre-foreclosure workout*.

The broker's ability to negotiate a short payoff with the lender depends on the type of loan encumbering the seller's property.

If the loan is an FHA-insured loan on an owner-occupied, single family residence, the lender may only accept a short payoff if the owner qualifies for **FHA pre-foreclosure** sale treatment. To qualify, the owner must be in default on at least three months' payments, in addition to other requirements. [HUD Mortgagee Letter 94-45]

Likewise, if the loan is a conventional loan covered by **private mortgage insurance** (PMI), the lender's willingness to negotiate a short payoff is subject to his ability to negotiate the settlement of a claim with the private mortgage insurer for the lender's loss on the short payoff without first foreclosing.

The short sale coordinator hustle

Later, before a buyer is located, the owner receives an advertisement soliciting owners whose debt exceeds the property's fair market value and who will lose their property by foreclosure. [See Figure 1]

The ad implies the owner will incur income taxes on the amount of debt forgiven by the lender as a discount, called *discharge-of- indebtedness* by the Internal Revenue Service (IRS).

Discharge of indebtedness

Taxwise, an individual's gross income includes income derived from any discharge-of-indebtedness. [Internal Revenue Code §61(a)(12)]

To compute the owner's adjusted gross income (AGI), the discharge-of-indebtedness income from the short payoff of a recourse loan is reported as trade or business income, rental/passive income, or investment/portfolio income, depending on the income category of the real estate purchased, improved or carried by the loan's proceeds. [See **first tuesday** Form 351 §1]

No discharge-of-indebtedness income is incurred by a seller on the short payoff of a **nonrecourse note** when property is sold, or disposed of by foreclosure or deed-in-lieu.

The excess amount of the nonrecourse loan over the property's fair market value is reported as part of the *price realized* on the short sale or foreclosure, and is part of the owner's **profit or loss** on the sale.

Taxwise, a nonrecourse note is a debt which, by facts surrounding its origination, limits the lender's or carryback seller's source of recovery to the security — a deficiency judgment is not allowed.

Thus, nonrecourse notes secured by real estate which are subject to California anti-deficiency laws, called *purchase money paper*, include:

- loans secured by owner-occupied, one-to-four unit residential property purchased with the loan proceeds;
- seller carryback notes secured only by the real estate sold [Calif. Code of Civil Procedure §580b]; and
- loans containing an exculpatory clause.

Figure 1

Example of an advertising targeting distressed homeowners, and the errors and misleading statement in the advertisement.

Of concern only on recourse loans

START OVER

Homeowner, does the debt secured by your property exceed the property's fair market value?

Not usually true on owner-occupied homes. Basis typically exceeds loan amount and creates a loss.

Nonrecourse paper.

Short sales and foreclosures create tax liability.

Wrong! No income on nonrecourse loan due to short sale. Might be a profit from sale if nonrecourse loans exceeds the owner's basis.

Example 1: Mr. and Mrs. Smith's home is secured by a $200,000 purchase money trust deed. The property is sold through a "short sale," where the lender accepts $150,000. The Smiths have a net gain from the discharge of indebtness of $50,000, taxable as ordinary income.

On nonrecourse note, no income reporting to avoid and no profit on the sale unless loan exceeds basis.

Wrong! No discharge-of-indebtedness income on trustee's sale for nonrecourse paper.

Example 2: Mr. and Mrs. Smith's home secured by a $200,000 purchase money trust deed is sold at a trustees foreclosure sale. The Smith's discharge of indebtedness of $50,000 is taxable as ordinary income when:

So would P.T. Barnum – "There's a sucker born every minute."

Wrong! Lenders loss on resale is neither income nor profit to the owner.

1) The lender takes title after a full credit bid of $200,000 and resells the home for $150,000.

2) The lender takes title after bidding in $150,000 at the sale.

Price realized is full amount of the nonrecourse loan. No income, but a profit exists if basis is lower than loan.

START OVER can help you avoid this potential tax liability when the value of your home is below the amount owed on the loan.

For a fee of one percent of the loan balance, **START OVER** will take title of your property.

True on nonrecourse paper, even if sold by foreclosure, deed-in-lieu or short sale

The transfer to **START OVER** is a sale at a price equal to the present loan balance. For tax purposes, no discharge of indebtedness is generated from the sale.

The ad states, if the owner transfers title to the company running the ad, the owner will avoid the **tax liability** resulting from a discharge-of-indebtedness on the discount taken by the lender to facilitate a short sale.

For a fee of $1,000 upward to 1% of the loan amount, the company, which we will call a *coordinator*, claims it will relieve the owner of the adverse tax consequences from the discharge-of-indebtedness by:

- taking title to the real estate; and
- completing any short sale themselves; or
- allowing the lender to foreclose against the coordinator because of nonpayment of installments.

After reading the ad, the owner is led to believe the sale of his real estate for a price less than the loan amount will result in a loan discount that will require the owner to report ordinary income and pay state and federal income taxes on discharge-of-indebtedness income.

The owner believes paying the fee of around $2,000 and transferring title to the coordinator is preferable to incurring a tax liability on discharge-of-indebtedness income of $44,804.44 ($194,804.44 minus $150,000).

§108 exclusion from reporting discount on recourse loan

An owner who incurs income from discharge-of-indebtedness on recourse financing does not need to report the discharge as income when:

- the discharge occurs in a Chapter 11 *bankruptcy*;
- the discharge occurs when the owner is *insolvent*;
- the loan discharged is qualified *farm indebtedness*; or
- the owner is not a C corporation and the debt discharged is qualified real estate *business indebtedness*. [IRC §108(a)(1)]

An owner is considered **insolvent** when the owner's liabilities exceed the current fair market value of all the owner's assets. [IRC §108(d)(1)]

However, the §108 exclusion from income becomes an offset which requires a reduction by the owner of his:

- net operating losses;
- general business credit;
- minimum tax credit;
- capital loss carryovers; or
- basis in other property. [IRC §108(b)(1)]

Does the advertisement correctly state the homeowner's tax reporting and tax liability exposure from a short sale handled by a coordinator who will take title?

No! The short sale of real estate encumbered by a **nonrecourse loan** with a principal balance exceeding the value of the real estate triggers profit/loss reporting of the discounted and discharged portion of the loan. The discount is considered part of the *price realized* on the sale.

Thus, the owner will incur and report no profit on the short sale (or foreclosure) — his **basis exceeds** the principal amount of the nonrecourse loan. The loan amount equals the price realized on the sale. [**Commissioner of Internal Revenue** v. **Tufts** (1983) 461 US 300]

Instead, the owner will incur a **personal loss** on the sale of $55,195.56. The owner's profit or loss from the sale of his residence is calculated by subtracting the owner's cost basis in the home, $250,000, from the **price realized** on the sale, the loan amount of $194,804.44.

The **fair market value** paid by the buyer for the real estate does not establish the *price realized* by the owner on the short sale when the real estate is overencumbered by a nonrecourse loan. Since the entire nonrecourse loan is satisfied at the time of the sale, the **principal remaining** on the loan becomes the price reported on the sale. [Revenue Regulations §1.1001-2(a)]

However, the sale involved the owner's personal residence. Thus, the capital loss that results when the seller's cost basis is greater than the price realized on the short sale is a personal loss. A **personal loss** cannot be used as an offset to shelter other income from being taxed. [IRC §165(c)]

Trustee's sale for nonrecourse note

Consider an owner whose depreciated cost basis in real estate is $125,000.

The real estate is encumbered by a nonrecourse $180,000 first trust deed note. The value of the real estate has fallen below the principal amount owed on the note.

The owner defaults on the note, and the real estate is sold at a trustee's sale.

Whether the real estate is sold at the trustee's sale for a full credit bid or on an underbid, the owner will have the same profit to report on the sale — a gain of $55,000 — which sets his maximum tax liability at 25% of the profit for the amount of depreciation deduction taken during ownership (limited of course to the total profit of $55,000).

A foreclosure sale is considered a disposition of real estate since it is *a voluntary sale* under the terms of the trust deed. The profit or loss on the foreclosure sale must be reported. [**Helvering** v. **Hammel** (1941) 311 US 504; **Electro-Chemical Engraving Co.** v. **Commissioner of Internal Revenue** (1941) 311 US 513]

At a trustee's sale, the price paid by the highest bidder is considered the fair market value of the real estate. [**BFP** v. **Resolution Trust Corporation** (1994) 511 US 531]

Thus, a full credit bid at the trustee's sale sets the fair market value at the principal amount owed on the note, not at the current appraised market value. The profit calculated is $55,000: the price of $180,000 being the debt, minus the owner's $125,000 basis in the real estate, equals $55,000 in profit to be reported.

If an amount less than the principal due on the nonrecourse note is bid to acquire the real estate, say $140,000, the fair market value of the real estate is considered to be the $140,000 bid. Since the fair market value of the real estate is below the outstanding debt due on the nonrecourse note, the owner has realized a price of $180,000 from the trustee's sale, the full amount of the nonrecourse note. [Tufts, *supra*]

Deed-in-lieu

Lenders occasionally accept a deed-in-lieu from the owner of encumbered property in exchange for the cancellation of a note when the outstanding principal balance is greater than the value of the real estate.

When the note evidences a nonrecourse debt, the owner will report the same tax consequences on a deed-in-lieu conveyance as reported on a voluntary sale or a foreclosure sale of the real estate, since the IRS considers a sale to have taken place.

The owner reports any profit or loss (price minus basis) on the deed-in-lieu conveyance of the real estate to the lender in exchange for cancellation of the nonrecourse note. [**Rogers** v. **Commissioner of Internal Revenue** (9th Cir. 1939) 103 F2d 790]

Short payoff, no sale —discharge of indebtedness

Consider an owner of real estate encumbered by a trust deed securing either a recourse or nonrecourse loan made to the owner or taken over by the owner. The trust deed holder offers the owner the opportunity to prepay the loan at a discount.

No sale of the real estate is involved.

The trust deed holder will accept as a payoff an amount equal to 90% of the unpaid principal balance. The owner agrees and pays off the note at a 10% discount.

Does the owner have reportable income on the discount in the form of discharge-of-indebtedness?

Yes! The owner **retained ownership**. Thus, he must report as income the discharge of indebtedness resulting from the discount on the loan. The discharge-of-indebtedness income is reported as income generated by the property securing the loan.

Taxwise, the amount of the discount received on prepayment of a loan is considered a discharge of indebtedness on both recourse and nonrecourse notes when the owner **retains ownership** in the real estate. Thus, the payoff of the loan at a discount does not give rise to a profit or loss since the owner did not sell the property. [Revenue Ruling 82-202]

Now consider a seller who carries back a note and trust deed. Later, the seller is in need of cash and offers his buyer a discount on the remaining balance if the buyer will prepay the carryback note he executed.

The buyer accepts the seller's offer and pays off the carryback note at a discount.

Is the amount of the discount on the carryback note considered income from the discharge of indebtedness, as in the case of a money loan?

No! The discharged amount of the carryback note becomes a reduction in the purchase price on the installment sale, since:

- the buyer was neither in Chapter 11 bankruptcy nor insolvent; and

- the discount would have been discharge-of-indebtedness income on a money loan. [IRC §108(e)(5)]

The **buyer's basis** is reduced by the amount of the purchase price reduction on the installment sale. On the buyer's resale of the property, the reduced basis will be subtracted from the price to report the profit or loss on the resale.

Deed-in-lieu to carryback seller

A deed-in-lieu of foreclosure, given by the buyer to a carryback seller deeding back the real estate sold, generates a profit or loss, not a reduction in the purchase price and cost basis since the buyer does not retain ownership.

For example, an owner's property is encumbered by a carryback note for an amount now in excess of the fair market value of the real estate.

The owner will no longer make payments on the note to avoid a foreclosure. The owner offers to give the seller a deed-in-lieu of foreclosure for cancellation of the carryback note.

The seller accepts the deed-in-lieu of foreclosure and cancels the note in exchange.

Can the owner treat the amount of the note which exceeds the fair market value of the real estate as a reduction in his original purchase price?

No! The owner cannot consider the discount a reduction in price or cost basis since the transaction, being an exchange of the real estate for cancellation of a **nonrecourse debt**, does not give rise to any discharge-of-indebtedness income. The principal amount remaining on the cancelled (nonrecourse) note is the price realized and reported on the sale/exchange by the deed-in-lieu. [IRC §108(e)(5)(C)]

Since the note is nonrecourse — a carryback note secured only by the real estate sold — and the amount owed exceeds the fair market value of the real estate, the price realized from the sale by a deed-in-lieu is the principal amount due on the note, not the fair market value of the property.

Thus, the profit or loss from the deed-in-lieu conveyance is calculated by subtracting the cost basis from the price realized (the principal remaining due on the carryback note).

Unless the basis has been reduced by depreciation or capital loss deductions, the basis will exceed the amount of the carryback note that is cancelled, and a capital loss will be incurred.

Thus, a deed-in-lieu transaction on a carryback note secured only by the real estate sold includes a profit or loss, and not discharge-of-indebtedness income. [Tufts, *supra*]

Recourse paper

On the sale of real estate subject to a short payoff to the secured lender, recourse paper is not given the preferential tax treatment given to nonrecourse paper.

The distinction between the tax aspects of recourse paper and nonrecourse paper is artificial and was created by the IRS commissioner. The treatment of recourse and nonrecourse loans as separate and distinct from one another is considered reasonable by the courts.

With recourse paper, when the price of the real estate sold is below the amount of the debt, the owner incurs a **tax liability** on income generated from discharge-of-indebtedness. Conversely, a nonrecourse

debt discounted on a sale only generates profits or losses subject to 25% (depreciation recapture) and 20% (long-term) tax rate ceilings.

For example, an owner's property is encumbered by a $200,000 trust deed. The trust deed note is a **recourse obligation** with deficiency judgment exposure for the owner. The real estate is only worth $160,000. The owner's cost basis in the real estate is $250,000.

The owner sells the real estate through a short sale. The net amount paid by the buyer for the real estate is $160,000. The lender accepts the net proceeds from the sale as a short payoff of the **recourse note**, and cancels the remaining unpaid balance of $40,000.

The owner's tax liability is as follows:

- the owner incurs a capital loss in the amount of $90,000 on the sale of the real estate — the price received at the sale, $160,000, minus the owner's basis, $250,000; and
- the owner incurs discharge-of-indebtedness income of $40,000.

Thus, the owner incurs both:

- a capital loss on the sale; and
- ordinary income on the discounted payoff of the recourse loan encumbering the property sold.

The capital loss is from the disposition of real estate; the ordinary income is from the discharge of indebtedness. Thus, the capital loss spills over to offset the ordinary income from the discharge of indebtedness.

Homeowner's recourse loans

Occasionally, a homeowner obtains an equity loan or refinances the existing loans encumbering his residence. **Equity loans** and **refinancing** are recourse loans since their net proceeds do not themselves finance the purchase or improvement of the residence occupied by the owner.

Again, on the sale of the owner's *personal residence*, the capital loss resulting when the basis exceeds the sales price cannot be written off or used to offset other income, including any income from discharge-of-indebtedness generated by discounts on recourse loans paid off on the sale. [**Vukasovich** v. **Commissioner of Internal Revenue** (9th Cir. 1986) 790 F2d 1409; IRC §165(c)]

Foreclosure of recourse loans

The owner of real estate in foreclosure incurs the same tax consequences on completion of the foreclosure sale under a recourse loan as are incurred on any other sale.

For example, real estate encumbered by a recourse loan is sold at a judicial foreclosure sale. The lender seeks a deficiency judgment on completion of the sale since the proceeds from the judicial foreclosure sale do not satisfy the outstanding principal balance on the loan.

Before entering a deficiency judgment, the court determines the fair market value of the real estate at the time of sale.

If the court finds the fair market value of the real estate is less than the amount of the net proceeds from the sale and the outstanding principal on the loan at the time of the sale, the deficiency judgment will be limited to the difference between the proceeds from the judicial foreclosure sale and the outstanding principal on the loan at the time of the sale. [CCP §580a]

To determine the profit or loss from the judicial foreclosure sale, the owner will report the proceeds from the sale (and the amount of any priority lien) as the amount realized. [**Aizawa** v. **Commissioner of Internal Revenue** (1992) 99 TC 197]

In order to calculate his profit or loss from the sale, the owner will use the fair market value of the real estate set by the foreclosure sale as the amount realized at the sale. [Rev. Regs. §1.1001-2(a)(2),(4)(ii);(c) Example 8]

If the owner pays the deficiency judgment, he will incur no tax liability for discharge-of-indebtedness. However, if the lender later cancels the deficiency judgment, the owner will have to report the amount unpaid on the deficiency judgment as discharge-of-indebtedness income.

If the bid at the judicial foreclosure sale is less than the fair market value, the lender is to report the difference as a discount, since it is surplus and not recoverable by the lender in the bid or deficiency judgment.

Similarly, consider the lender who forecloses on a recourse loan by a trustee's sale. The high bid at the sale is for an amount which is less than the principal amount remaining on the recourse loan.

The low trustee's sale bid on recourse financing triggers tax reporting of both a profit/loss and discharge-of-indebtedness income on completion of the sale.

The **profit/loss** is calculated using the amount of the bid as the price realized on the sale, from which the owner's cost basis is subtracted to derive the profit/loss on the sale.

The amount of the high bid at the trustee's sale sets the fair market value of the real estate for calculating the discharge-of-indebtedness income on recourse paper.

The owner incurs discharge-of-indebtedness income on account of the underbid at the trustee's sale on the recourse loan, since at a trustee's sale the lender waives his right to collect any deficiency — the owner being released of any further liability on the recourse loan. [Rev. Regs. §1.1001-2(a)(2)]

The discharge-of-indebtedness income is the amount by which the recourse loan exceeds the fair market value received for the real estate (the high bid at the non-judicial foreclosure sale). [Rev. Regs. §1.1001-2(c), Example 8]

Recourse note — deed-in-lieu

An owner who conveys real estate to the secured lender by a deed-in-lieu for the cancellation of a recourse loan will incur the same tax liability as on a foreclosure sale, the price accepted by the lender being equivalent to the highest bid.

For example, a recourse note is secured by real estate which has a market value less than the outstanding principal balance on the note. The owner conveys the real estate to the lender on a deed-in-lieu of foreclosure, and the lender cancels the full amount of the debt in exchange.

In the deed-in-lieu provisions, the lender agrees the amount of the debt cancelled equals the fair market value of the real estate.

Thus, the amount of the cancelled loan is considered the fair market value of the real estate. The owner calculates his profit/loss from the deed-in-lieu sale by subtracting from his basis the amount of the loan

discharged since it is the price he received for conveying the property. [Rev. Regs. §1.1001-2(c), Example 8]

Now consider the lender who accepts a deed-in-lieu of foreclosure on a recourse loan, agreeing:

- the fair market value of the real estate is less than the outstanding loan balance; and
- the lender will cancel the entire outstanding balance of the recourse loan.

The price realized on the exchange and used to calculate the profit/loss from the conveyance of the real estate by a deed-in-lieu is the property's fair market value as agreed to by the owner and the lender.

Since the amount of the recourse loan exceeds the fair market value agreed to, the owner will also incur discharge-of-indebtedness income. [**Gehl** v. **Commissioner of Internal Revenue** (1994) 102 TC 784]

Thus, the deed-in-lieu on the recourse financing when the debt exceeds the agreed-to fair market value results in tax reporting as follows:

- **profit** in the amount of the excess in the agreed-to fair market value over the owner's basis; and
- **income** from the discharge of indebtedness in the amount the debt exceeds the agreed-to fair market value of the real estate. [Rev. Regs. 1.1001-2(c), Example 8; Rev. Rul. 90-16]

Attempted avoidance of discharge-of-indebtedness income

Consider the owner of real estate encumbered by a recourse loan in excess of his basis who transfers title to a coordinator. The coordinator agrees to take title to real estate on payment of a fee by the owner.

The **coordinator** does not perform any activities on taking title which would indicate the coordinator intends to become the owner-operator of the real estate, such as escrowing the transaction, ordering beneficiary statements, assuming the loan, obtaining title insurance, obtaining hazard insurance, maintaining the property, making payments on the trust deed loans, placing utilities in the coordinator's name, etc.

The agreed-to sales price on the coordinator's taking title is the amount of the recourse loan, even though the amount owed on the loan exceeds the real estate's fair market value. The coordinator does not assume the loan, a breach of the trust deed's due-on-sale provision, triggering the lender's right to call the loan.

The owner reports a profit/loss on the transfer to the coordinator by subtracting the cost basis in the real estate from the balance on the loan — the price realized on the "sale."

Since the owner's cost basis exceeds the loan balance, a loss results on the sale.

The coordinator does not make payments on the recourse loan. The owner remains in possession and does not pay rent.

The real estate is ultimately sold at a trustee's sale on a bid in an amount less than the outstanding principal balance due on the loan.

On completion of the trustee's sale, the institutional lender files:

- a 1099-A to report the foreclosure sale; and
- a separate information return to report the discharge of indebtedness due to the underbid. [IRC §§6050J; 6050P]

The 1099-A includes:

- the name of the borrower, which will be the owner since the coordinator did not assume responsibility for the loan;
- the amount of the loan at the time of the foreclosure; and
- the amount of the loan satisfied by the bid at the foreclosure sale. [IRC §6050J(c)]

Institutional lenders are also required to snitch on borrowers for any discharge-of-indebtedness income by filing a discharge-of-indebtedness information return. The lender will also send a copy of the discharge-of-indebtedness information return to the owner. [IRC §6050P(a),(d)]

Thus, the owner will appear to the IRS to have received discharge-of-indebtedness income, reducing the amount of profit previously reported by the owner.

Even though the owner did not hold title to the real estate at the time of the foreclosure, a reporting conflict will arise for the owner who transferred the property to the coordinator, subject to recourse financing, in an attempt to avoid discharge-of-indebtedness income.

The owner incurs tax liability for discharge-of- indebtedness income, which will be assessed if the IRS discovers the true purpose of the transfer of title to the coordinator — tax evasion.

The conveyance of the real estate by sale to the coordinator is a sham transaction. The coordinator had no intention of acting as the owner and operator of the real estate.

In addition, the owner's payment of the fee in order for the coordinator to take title and perform services for the owner probably created an agency. The IRS should consider the coordinator an agent of the owner, who is merely holding title to the real estate while handling settlement negotiations with the owner's lender or locating buyers before a foreclosure sale occurs.

The owner who has already reported a profit/loss from the "sale" of the real estate to the coordinator will be called on by the IRS to amend the return for the year the profit/loss was reported, since the transfer of title was not a sale but a *masked brokerage agreement.*

The owner will then have to report a profit/loss from the foreclosure sale, and discharge-of-indebtedness income from the underbid. The owner was released by the lender from a deficiency on completion of the trustee's sale in which the real estate sold for a bid amount less than the recourse note.

Editor's note — We do not here address the issue of an advance fee, Department of Real Estate (DRE) regulations controlling collection and accounting, or the coordinator's duty of care as an agent.

Subject-to conveyancing

The owner contemplating the use of a coordinator should also consider the potential liability to the lender on a recourse loan for a deficiency judgment.

When real estate is conveyed subject to an existing recourse note, the owner is still liable for any deficiency on the recourse loan should the lender pursue collection by a judicial foreclosure. [**Braun** v. **Crew** (1920) 183 C 728]

Since the coordinator does not enter into a formal assumption agreement with the owner or the lender, the coordinator will not be liable to either the owner or the lender on the loan should a deficiency judgment be sought by the lender.

Chapter 47 Tiered tax rates on profit

This chapter sets forth the different tax rates for ordinary income and profit, the definition of terms and the accounting procedures for taxing profits.

The batching and taxing of gains

As a professional tool in the hands of a broker and his agents, knowledge about income tax law is a valuable asset to be put to work when assisting clients in real estate transactions. Tax knowledge, dispensed as advice in an **opinion** given to a client by a broker or sales agent, becomes goodwill. In turn, the earning power of the goodwill generates further employment, i.e., more and superior listings, repeat clientele and the entrusted handling of larger dollar transactions.

Counseling a client on the tax aspects of a sale, reinvestment or exchange early on in an agency relationship typically induces an ongoing tax discussion. Of course, the objective of the discussion is to achieve the most favorable tax results available to the client without altering the underlying financial benefits and risks of a sale.

The earlier in the client relationship the tax discussion is held, the more likely the client is to consult with and ask questions of **other competent professionals** about his tax-related discussion with his broker. An early consultation with others allows the client to consider alternatives suggested by his broker, such as an installment sale or the purchase of replacement property in a §1031 reinvestment plan.

Encouraging a client to discuss the transaction with other advisors available to the client (or allowing the broker to do so before the client contacts them) actually results in their cooperation with the broker, unless the client has objectives not disclosed to the broker.

In situations involving other professional advisors, the broker still has a duty of care owed to his client to present the client with information the broker believes may impact the client or be contrary to the advice given to the client by others, such as the client's attorney. [**Brown** v. **Critchfield** (1980) 100 CA3d 858]

Through the collective efforts of all advisors, the transaction will be structured to meet the client's needs, including obtaining the best possible tax result under the circumstances.

A broker's influence over a client's decisions should be maintained, as it is important. The changing market conditions and the innuendos and nuances of real estate negotiations are usually better known to those brokers and agents who are regularly involved in real estate transactions than their clients. Also, alliances built by a broker with other professionals who are brought into a transaction by a client survive long after the transaction involving them is closed and mostly forgot.

Also, a broker's failure to recognize and coordinate activity in a transaction with other advisors of the client can produce disastrous results for the broker. A broker who **persuades** a client to rely on his advice over the contrary (and correct) advice of other professionals will be liable for any losses suffered by the client due to his (unsound) advice. [**In re Jogert, Inc.** (1991) 950 F2d 1498]

Worksheet estimates for the seller

The sale of every parcel of real estate, except dealer property, produces a profit for a seller if the price exceeds the seller's cost basis in the property. This profit formula, coupled with an understanding that the taking of a profit on the sale typically produces a tax liability owed to the federal (and state) tax collecting agency, is commonly known to all brokers and sales agents who represent sellers. This knowledge is probably also held by most sellers. Thus, a discussion entered into with a seller, initiated by the seller's broker or listing agent, will come as no surprise to the seller.

Before commencing a discussion about the tax aspects of a sale, a worksheet needs to be prepared. On it, the listing agent breaks down the profit taken on a sale into the different types of gains, called *batching*. Without first batching the gains, the seller's tax liability on closing a sale cannot be estimated. A secondary objective sought by a listing agent during a review of the profit tax liabilities estimated on the worksheet is a follow-up discussion on how to *exclude*, *exempt* or *defer* the tax.

Thus, the seller who initially sought only to "cash out" his ownership of real estate might be converted to a §1031 reinvestment plan and acquire a replacement property. As an alternative, the seller might structure a sale as an installment sale to retain the earning power of his untaxed equity until the deferred tax on the profit is actually paid.

The worksheet conveniently suited for this introductory discussion about profit taxes is entitled the Individual Tax Analysis Form (INTAX). [See Form 351 accompanying this chapter]

The top half of the form is a mere review of the items of income, profit and loss which can be gathered to set the seller's taxable income or loss. However, the estimated taxable income for the year of the sale for a high income earner is not needed to batch the gains and estimate the profit tax on a sale.

A seller who is a **high income earner** is more likely to respond favorably to the agent's tax analysis than a low income earner. The agent's INTAX analysis (of the profit only) should be made at the time the listing is taken (or shortly thereafter), and then again when a purchase agreement offer is reviewed for acceptance or a counteroffer. The discussion with the seller on each occasion should be limited to the amount of his profit on the sale, the batching of his different gains (in the profit) and the tax liability due on those gains.

The INTAX worksheet contains separate columns for calculating the standard income tax (SIT) and the alternative minimum income tax (AMT). The distinction between them is critical as it may well affect the seller's tax liability for his business, professional and investment income. However, the distinction has no influence on the profit taxes due on the sale of a capital asset. The taxation of gains (profit) on a sale are the same no matter the other income and deductions of a high income earner.

Thus, a listing broker's tax discussion of a capital asset is limited to the types of gains contained in the profit on the sale, and the tax due on those gains. [See Form 351 §§5.3 and 5.4]

It is unnecessary to use the INTAX to assist a buyer of real estate in the selection of property based on tax consequences. The Annual Property Operating Data (APOD) sheet provides the depreciation schedule for the only tax benefit available to a buyer during his ownership and operation of the property. [See **first tuesday** Form 352]

Further, the increase or decrease in the buyer's annual taxes brought about by his acquisition of a property is calculated on a Comparative Analysis Projection (CAP) Worksheet. [See **first tuesday** Form 353 §5.3]

INDIVIDUAL TAX ANALYSIS (INTAX)

Date:_____________, 20______

Client: ____

Prepared by: ____

This form and the Comparative Analysis Projection (CAP) (Form 353) are used in tandem to determine the federal tax impact on a proposed purchase or sale.

Items	Standard Income Tax (SIT)		Alternative Minimum Tax (AMT)	
1. ADJUSTED GROSS INCOME (AGI)				
1.1 Salary/professional fees/wage	(+) $________		(+) $________	
1.2 Trade or Business income/loss	(+/-) $________		(+/-) $________	
1.3 Sale of business property.	(+/-) $________		(+/-) $________	
1.4 Rental income/profit	(+) $________		(+) $________	
1.5 Loss spillover of rental sales	(-) $________		(-) $________	
1.6 Business related rental operating loss	(-) $________		(-) $________	
1.7 Investment category income.	(+) $________		(+) $________	
1.8 Investment category capital losses (up to $3,000)	(-) $________		(-) $________	
1.9 Retirement, pension and annuity plans.	(-) $________		(-) $________	
1.10 ADJUSTED GROSS INCOME		$________		$________
2. REAL ESTATE RELATED DEDUCTIONS				
2.1 First/second home interest ($1,100,000 loan cap).	(-) $________		(-) $________	
2.2 Property taxes on residences	(-) $________		NONE	
2.3 $25,000 rental loss deduction	(-) $________		(-) $________	
2.4 TOTAL REAL ESTATE RELATED DEDUCTIONS		(-) $________		(-) $________
3. OTHER DEDUCTIONS AND EXEMPTIONS				
3.1 Medical and dental	(-) $________		(-) $________	
3.2 State income taxes.	(-) $________		NONE	
3.3 Other deductions (charitable contributions, etc.) . .	(-) $________		(-) $________	
3.4 Personal exemption	(-) $________		NONE	
3.5 AMT exemption	NONE		(-) $________	
3.6 TOTAL OTHER DEDUCTIONS & EXEMPTIONS		(-) $________		(-) $________
4. TAXABLE INCOME		$________		$________
5. TAX BATCHING				
5.1 Net profits and short term losses	$________		$________	
5.2 Ordinary Income (Line 4 minus Line 5.1, but not less than zero)	$________		$________	
(a) Tax: See Standard and AMT Tax Bracket Rates for line 5.2 . .		$________		$________
5.3 Unrecaptured depreciation gain	$________			
(b) Tax: 15% in lowest bracket; 25% on balance		$________		$________
5.4 Long-term capital gain.	$________			
(c) Tax: 5% in lowest bracket; 15% on balance . . . . (Lines 5.2, 5.3, and 5.4 are not to exceed Line 4)		$________		$________
6. INCOME TAX – the **greater** amount of:(Line a,b,c)		$________ or		(Line a,b,c) $________

When a seller enters into a §1031 reinvestment plan and acquires a replacement property of equal-or-greater debt and equal-or-greater equity than the property he sold, he has no profit which will be taxed. (Other formulas produce the same no-tax result.) The avoidance of tax on the profit is demonstrated by the preparation of a Profit and Basis Recap Sheet. [See **first tuesday** Form 354]

However, the seller's §1031 reinvestment plan might entitle him only to a **partial §1031 exemption** due to the withdrawal of cash, receipt of a carryback note or a reduction in mortgage debt on the reinvestment. Here, the INTAX form section for batching the profit which will be taxed is most informative since it will help establish the amount of cash the seller will need to pay profit taxes on the sale in his partial §1031 transaction. [Internal Revenue Code §1031(b)]

The 25% and 15% profit tax ceilings

Typically, the sale of investment real estate or business-use real estate held for more than one year is at a price greater than the depreciated cost basis remaining in the property. Thus, the seller **takes a profit** on the sale.

The *gross profit* taken on a sale is the **difference between** the sales price and the seller's remaining cost basis in the property he sold (price minus basis equals profit). Deduct the **transactional costs** of the sale from the gross profit and the result you get is the *net profit*.

Net profit, like ordinary income, is taxed, unless *exempt* or *excluded* (or reduced by other losses, called an *offset*). [IRC §1001]

However, net profit is taxed as a **gain** and not as ordinary income. Several types of gain exist within the net profit on a sale, each gain having a different tax rate.

Before taxing the amount of profit taken on a sale of property, the amount is reduced by all short-term and long-term **capital losses** (current and carried forward) the seller has incurred due to other sales within the income category for the property sold. Thus, the net profit is established within each of the three income categories (business, passive and portfolio).

The net profits from each income category are then combined to set the owner's net profits for the year, called *net capital gains* by the IRS. It is the net capital gains that are batched by type of gain and taxed, unless first offset by losses incurred by the owner in his rental operations or business. [See IRS Form 1041 Schedule D, Part IV]

The tax rates applied to net profit taken on the sale of real estate depend on the type of gains the profit represents.

Net profits from real estate sales include gains, such as:

- *recaptured gain*, represented by the amount of excess *accelerated depreciation* (occasionally taken on acquisitions prior to mid-1986) over straight-line depreciation for the period, which is taxed at **ordinary income** rates ranging from 10% to 35%, a type of gain which will not exist on a sale after 2005;
- *unrecaptured gain*, represented by the total amount of *straight-line depreciation* deductions taken on the property sold (limited to the profit on a sale when the sales price is less than the price the seller paid for the property), which is taxed at the maximum rate of 25% [IRC §1(h)(1)(D); see Form 351 §5.3]; and

- *long-term gain*, also called *adjusted net capital gain* by the IRS, represented by the amount of profit remaining after subtracting all depreciation deductions (unrecaptured gain) from the net profit, which is taxed at the maximum rate of 15%. [IRC §1(h)(1)(C); see Form 351 §5.4]

Recaptured gain has no relevance today. For properties acquired in 1985 or early 1986, and then depreciated on an 18- or 19-year *accelerated cost recovery schedule (ACRS)*, only a very small portion of the profit on a sale in 2005 will be taxed at ordinary income rates, and none in 2006 and beyond. All other properties, no matter when acquired, will, as a result of today's cost recovery schedules, have no excess depreciation (over the straight-line amount) to declare. Thus, no portion of their profits will be taxed at ordinary income rates.

Unrecaptured gain is the deceptive title applied to the amount of all straight-line depreciation deductions taken on a property. Thus, on the sale of property, the portion of the net profit produced by the depreciation the seller deducted during the period of his ownership will be taxed at a maximum rate of 25% as unrecaptured gain.

For example, a seller of a rental property paid $1,000,000 for the property 10 years ago. His depreciation deductions taken during his ownership total $250,000, approximately 1/3 of the value of the improvements when he bought the property. He is now selling the property for $1,600,000, a profit of $850,000 over his remaining cost basis of $750,000. Also, his taxable income from other sources pushes him into the 28% ordinary income tax bracket. [See Form 351 §4]

The seller's profit of $850,000 is now broken down — *batched* — into:

- **unrecaptured gain**, consisting of the $250,000 in depreciation deductions, which is taxed at the 25% rate for a tax liability of $62,500 [See Form 351 §5.3]; and
- **long-term gain**, consisting of the remaining profit of $600,000, which is taxed at the 15% rate for a tax liability of $90,000.

The **long-term gain** is that portion of the net profit represented by the increase in the sales price received by the seller over the amount the seller paid to acquire the property (plus or minus new or destroyed improvements). If the long-term gain is not offset by losses incurred by the owner, the amount of the gain will be taxed at the maximum rate of 15%.

The reverse order of descending rates

Sometimes the net profits from a sale are greater than the seller's taxable income for the year of the sale due to excessive operating losses experienced by the seller on this or other properties (expenses exceeded income in rentals or the owner's business). If profits are greater than the taxable income, the profits taxed are limited to the amount of the taxable income. Thus, excess rental or business operating losses have **offset profits** on the sale.

However, profits are offset from taxation in the **reverse order of descending rates**. Thus, the result is that the lowest profit bracket of 15% (long-term gains) is the first to be offset by the owner's operating losses.

For example, consider the same facts as in the prior example, except that the seller suffered a $200,000 loss operating his rentals and his business (which motivated him to sell the property). Thus, his taxable income amounts to $650,000, less than the $850,000 profit taken on the sale. He will pay profit tax only on the $650,000 taxable income as follows:

- an **unrecaptured gain** of $250,000, taxed at the 25% rate; and

- a **long-term gain** of $400,000, consisting of only a portion of the remaining $600,000 balance of the profit, and taxed at the 15% rate for a tax liability of $60,000, not $90,000, the amount which would have been paid without the operating losses.

Thus, the seller receives a tax savings of $30,000 to subsidize 15% of the seller's $200,000 operating loss.

Other types of profit do exist. Profit on the sale of coins and art is called a *collectibles gain* and is taxed at a maximum rate of 28%, unless the collectibles sold are the subject of a §1031 reinvestment exemption. Profit taken on the sale of small business stock is called a *§1202 gain* and is also taxed at a maximum rate of 28%. [IRC §§1(h)(4); 1(h)(5); 1(h)(7)]

Netting gains and taxing priorities

The total amount of all income, profits and allowable losses from each income category is called *adjusted gross income (AGI)*. AGI, less any personal and rental loss deductions, becomes the seller's *taxable income*. [IRC §63(a)]

To determine the tax liability of the seller, the **taxable income** is broken down into two major components:

- *net profit* (net capital gain) [See Form 351 §5.1]; and
- *ordinary income*. [See Form 351 §5.2]

To accomplish this breakdown of the taxable income, the net profits within each income category are added together. The combined total is then entered as the **net profit component** of the taxable income. [See Form 351 §5.1]

The combined net profit is then subtracted from taxable income. The result is the amount which will be taxed as ordinary income. [See Form 351 §5.2]

Ordinary income is taxed at SIT rates ranging from 10% to a ceiling of 35%, or at AMT rates of 26% and 28%, whichever produces the greater amount of taxes. [See Figure 1]

Batching gains to set taxes

To calculate the tax on **net profits**, profits are broken down and *batched* into the types of gain which constitute the net profit. Then, profits are taxed by their type of gain in the **order of descending rates**, until no profit remains to be taxed:

- first, any *recaptured gain* (excess depreciation), taxed at ordinary income rates (10% to 35%);
- next, any *collectibles gain* and business stock gain, taxed at a 28% rate;
- next, any *unrecaptured gain* (straight-line depreciation), taxed at a 25% rate; and
- last, any *long-term gain* not offset by operating losses from rentals or business, taxed at a 15% rate. [See IRS Form 1041, Schedule D Part IV]

Earnings on the sale of **dealer property**, also called *inventory*, are reported as business income, not profits on the sale of assets. Dealer property is property held primarily for sale to customers of a business, not for investment or productive use in a business. [IRC §1231(b)]

Figure 1

2005 Tax Rate Schedule

Single		
If taxable income is over —	**But not over —**	**The tax is:**
$0	$7,300	10% of the amount over $0
$7,300	$29,700	$730 plus 15% of the amount over 7,300
$29,700	$71,950	$4,090.00 plus 25% of the amount over 29,700
$71,950	$150,150	$14,652.50 plus 28% of the amount over 71,950
$150,150	$326,450	$36,548.50 plus 33% of the amount over 150,150
$326,450	no limit	$94,727.50 plus 35% of the amount over 326,450

Married Filing Jointly or Qualifying Widow(er)		
If taxable income is over —	**But not over —**	**The tax is:**
$0	$14,600	10% of the amount over $0
$14,600	$59,400	$1,460.00 plus 15% of the amount over 14,600
$59,400	$119,950	$8,180 plus 25% of the amount over 59,400
$119,950	$182,800	$23,317.50 plus 28% of the amount over 119,950
$182,800	$326,450	$40,915.50 plus 33% of the amount over 182,800
$326,450	no limit	$88,320 plus 35% of the amount over 326,450

Married Filing Separately		
If taxable income is over —	**But not over —**	**The tax is:**
$0	$7,300	10% of the amount over $0
$7,300	$29,700	$730 plus 15% of the amount over 7,300
$29,700	$59,975	$4,090 plus 25% of the amount over 29,700
$59,975	$91,400	$11,658.75 plus 28% of the amount over 59,975
$91,400	$163,225	$20,457.75 plus 33% of the amount over 91,400
$163,225	no limit	$44,160.00 plus 35% of the amount over 163,225

§121 principal residence exclusion

Profits remaining on the sale of a **principal residence** which are not offset by the IRC §121 $250,000 per person *profit exclusion* are reported as a short- or long-term gain (held, respectively, less or more than one year).

For example, a homeowner and spouse paid $250,000 years ago for their principal residence which they are now offering for sale at $900,000. On the sale, they will take a profit of $650,000 since a principal residence is a capital asset. They qualify for a combined §121 exclusion from profit tax of $500,000. Thus, they must report a profit of $150,000.

The homeowners did not take any depreciation deductions on the residence as a home office or as a rental, in whole or in part. Thus, their cost basis remains unchanged as the price they originally paid for the residence.

Further, their taxable income exceeds the profit on the home and places them in the 28% ordinary income reporting bracket. Thus, the $150,000 in profit remaining (after deducting their combined $500,000 principal residence profit exclusion) will be reported as a long-term capital gain and taxed at the 15% rate, a tax liability on the sale of the residence of $22,500. [See Form 351 §5.4]

However, no loss on the sale of the principal residence may be reported or used to offset investment or business category income or profits.

Installment sale profit reporting

Also, the profit allocated to any note carried back by a seller on an IRC §453 **installment sale** is reported each year as the principal payment is received. The profit allocated to the principal in the installment payments is also batched (by the type of gains taken on the sale) and reported as principal is received on the note. The first profits in the down payment and installments to be taxed (until they no longer exist) are the gains with the highest rate among the gains involved.

For example, real estate used to provide warehouse space for a seller's business is sold for the **net sales price** of $1,000,000. Terms include a $100,000 down payment, the buyer's assumption of a $400,000 mortgage and the execution of a $500,000 carryback note for the balance of the price. Depreciation deductions of $150,000 have been taken during his ownership, leaving an adjusted cost basis of $500,000 at the time of sale. Thus, the profit on the sale is $500,000 (price minus basis equals profit).

As a result, the installment sale's *contract ratio* of **profit-to-equity** ($500,000/$600,000) is 83.3%. Accordingly, the down payment of $100,000 is 83.3% profit ($83,333) and the carryback note of $500,000 is 83.3% profit ($416,666), both amounts making up the total profit on the sale.

Also, as the result of batching, $150,000 of the profits is *unrecaptured gain* (depreciation), which will be reported first before reporting any long-term gain on the sale. Thus, profit taxes will be paid as cash is received from the down payment, and later as installments of principal are received.

Thus, the entire profit of $83,333 in the down payment will be reported as unrecaptured depreciation gain taxed at the 25% rate. The balance of the unrecaptured depreciation gain will be reported on 83.3% of the principal payments as these are received on the carryback note, until the unrecaptured gain has been fully reported. All remaining profit received in subsequent installments on the carryback note will be long-term gains taxed at 15% when received. [See Form 351 §§5.3 and 5.4]

The alternative minimum tax

The tax on ordinary income must be **calculated twice**, once under the SIT rates and again under the AMT rates.

Not so for profits.

Whichever SIT or AMT calculation sets the highest amount will be the tax paid on the ordinary income portion of the taxable income. [IRC §55(a); see Form 351 §§5.2(a) and 6]

The AMT rates on **ordinary AMT income** (taxable income less profits) are:

- 26% on amounts up to $175,000; and
- 28% on amounts over $175,000. [IRC §55(b)(1)(A)]

When reporting AMT, straight-line depreciation taken on a property is reported as **unrecaptured gain** and taxed at 25%, the same handling and rate as the ceiling rate for SIT treatment of unrecaptured gain.

Likewise, the 15% long-term gain rate ceiling applies to AMT reporting of long-term profits. [IRC §55(b)(3)(c)]

Chapter 48 Commingling rental losses and other income

This chapter presents the use of rental operating losses to offset business and investment income and profits.

The part-time landlord

A real estate broker owns rental properties and a brokerage business. Weekly, the broker works 30 hours in his brokerage business and spends an average of 10 hours on management, care and maintenance of his rentals.

The broker interviews prospective tenants, checks out their credit and prior rental history, and prepares and signs all leases. He also collects rents and arranges for all repairs and maintenance.

At the end of the year, the broker has a net operating loss to report from his rental activities. Can the broker use the loss from his rentals to offset the income from his brokerage business?

Yes! Rental operating losses incurred by owners who are active in rendering services as real estate licensees, landlords, investors, developers or builders qualify to offset business and investment income and profits as an adjustment reducing the owner's adjusted gross income (AGI). [Internal Revenue Code §469]

Reporting rental operating loss

All residential and nonresidential rental income, profit or losses, are reported in the passive income category, separate and not commingled with income in the trade or business category or the investment/portfolio category.

Reportable operating losses from a rental property first *offset* operating income and sales profits from other rentals. Remaining losses then offset any passive category income from other sources, such as income received by the owner as a limited partner in a partnership business or other passive business opportunity holding.

Any rental operating losses remaining after offsetting income and profits within the passive category are then reallocated to the rental properties generating the operating losses and accounted for as *suspended losses*, unless the taxpayer annually qualifies to use the losses as either:

- an **adjustment** to the AGI; or
- a **deduction** up to $25,000 from the AGI. [See Figure 1]

For example, a married couple incurs a reportable operating loss on their *rentals,* both residential and nonresidential property.

Neither spouse is in a business related to real estate. One spouse is a doctor and manages the couple's rentals. The other spouse is unemployed and uninvolved in any aspect of the rentals.

The couple does not qualify to **deduct** any part of their loss from their AGI under the limited $25,000 annual operating loss rules to reduce their taxable income on their joint return, since their AGI exceeds $100,000. [IRC §469(i)]

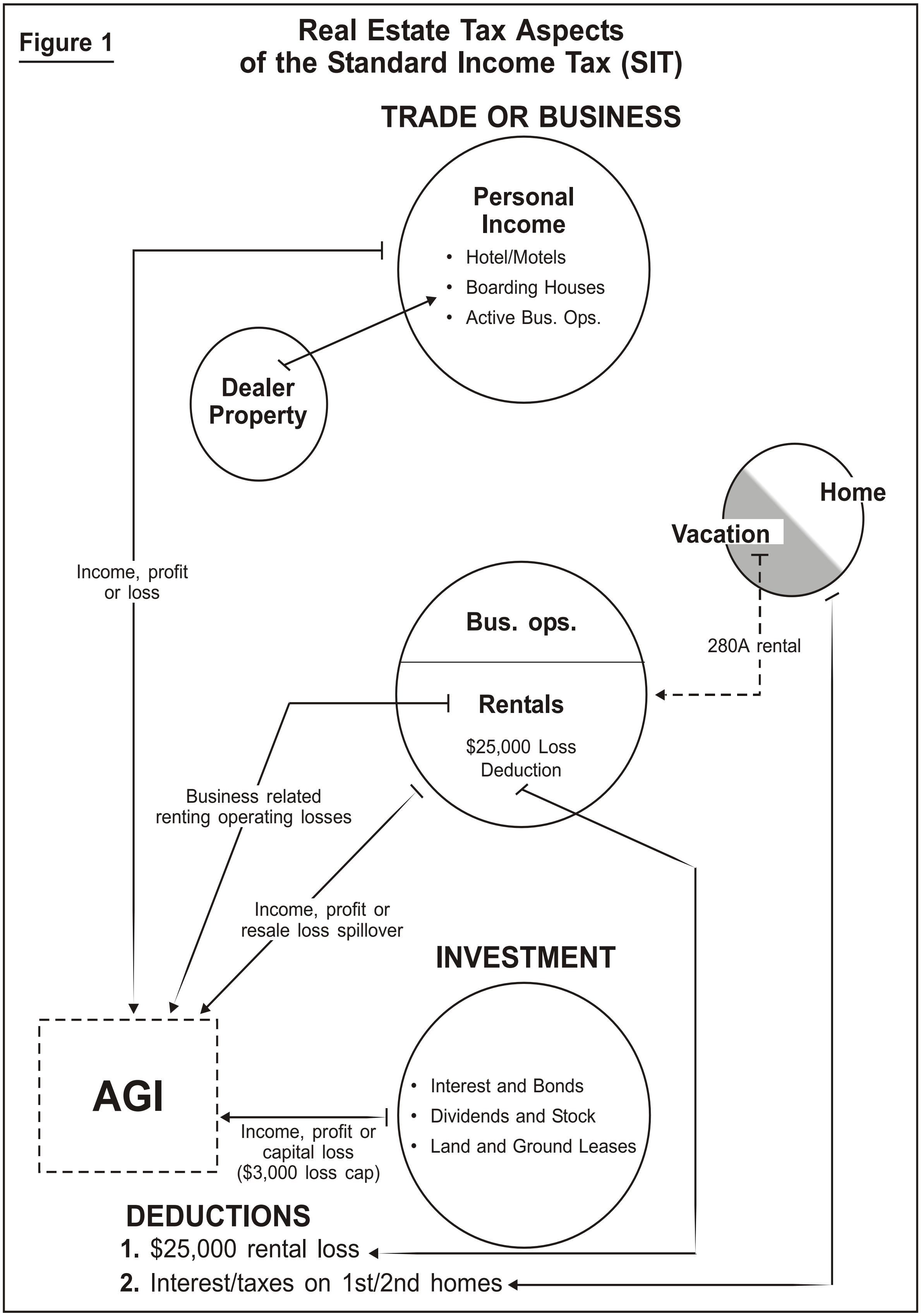


Figure 1
Real Estate Tax Aspects
of the Standard Income Tax (SIT)
TRADE OR BUSINESS
Personal Income
• Hotel/Motels
• Boarding Houses
• Active Bus. Ops.
Dealer Property
Home
Vacation
Income, profit or loss
Bus. ops.
280A rental
Rentals
$25,000 Loss Deduction
Business related renting operating losses
Income, profit or resale loss spillover
INVESTMENT
AGI
• Interest and Bonds
• Dividends and Stock
• Land and Ground Leases
Income, profit or capital loss ($3,000 loss cap)
DEDUCTIONS
1. $25,000 rental loss
2. Interest/taxes on 1st/2nd homes

However, either spouse, independent of the other, can qualify the rental operating loss as an *adjustment* to reduce their AGI. [IRC §469(c)(7)(B)]

To qualify their rental operating losses as an AGI adjustment, the unemployed spouse will assume all duties as manager of the couple's rentals. The spouse must spend sufficient time to qualify as:

- an **owner-operator** of a *real estate-related* trade or business; and
- a **material participant** in the ownership of the rentals. [IRC §469(c)(7)(B)]

Real-estate-related business

The **real-estate-related trade or business** of a landlord, who is acting on his own behalf or representing others as their broker or builder, includes real estate activities such as:

- development or redevelopment;
- construction or reconstruction;
- acquisition;
- conversion;
- rental;
- operation;
- management;
- leasing; or
- brokerage. [IRC §469(c)(7)(C)]

For a landlord to qualify as an **owner-operator** of a real-estate-related trade or business, two criteria must be met:

- the business must render professional real estate **services, or manage, invest or develop** real estate; and
- the landlord must spend a minimum amount of **time** in the real-estate-related business. [See Figure 2]

For instance, a landlord who spends sufficient time **acquiring, managing or leasing his own rentals** is in a *real-estate-related business* — even though the income or losses from rental operations is always reported as passive category rental income and cannot be classified as trade or business category income.

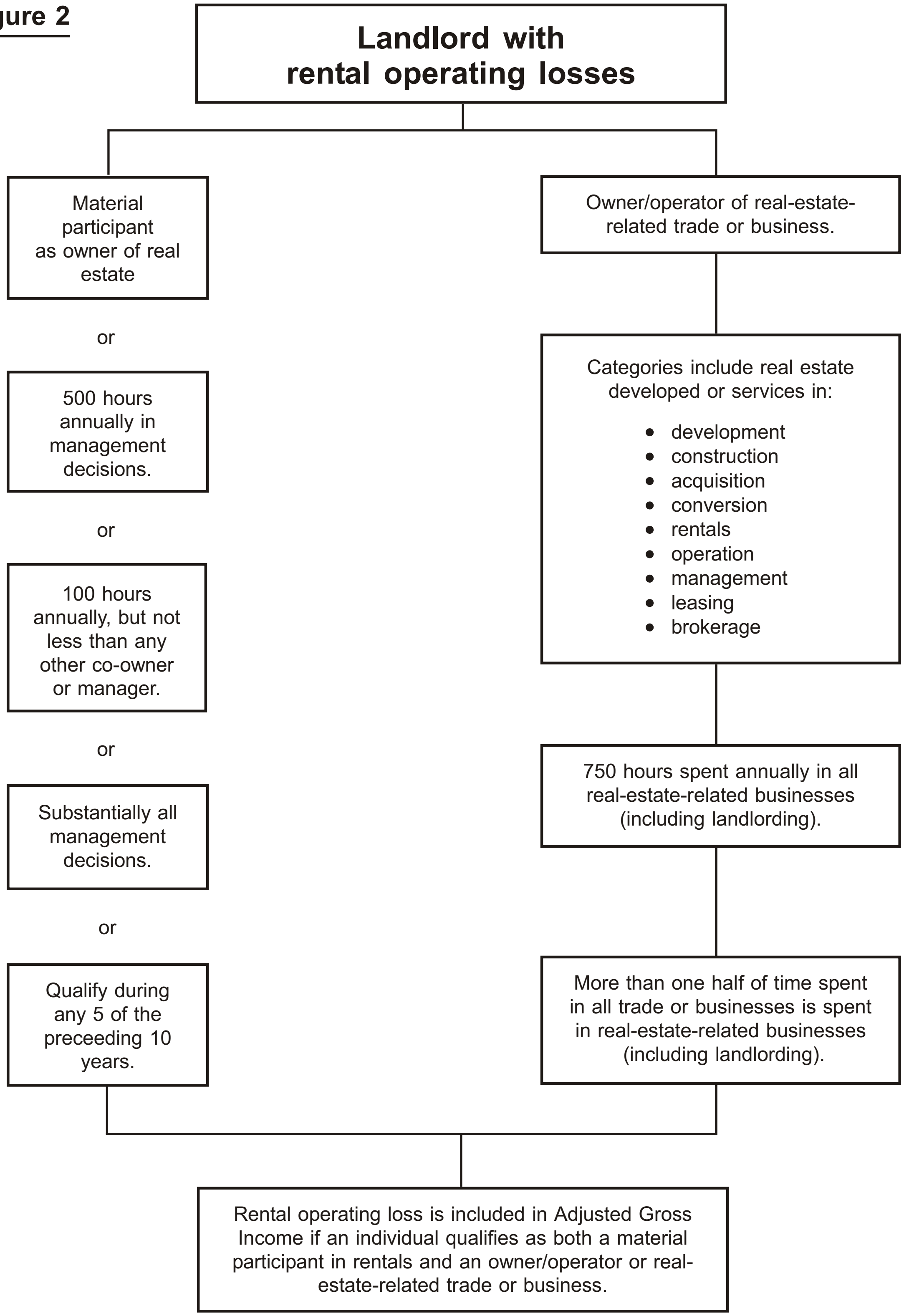
Yet, adjustments to the AGI include (otherwise excluded) rental operating losses if the landlord qualifies as being in a *real- estate-related business activity*. Rental operations qualify as a real-estate-related trade or business if the landlord spends sufficient time on his duties as a landlord. [See **first tuesday** Form 351]

Likewise, a real estate broker who spends **sufficient time managing** properties for clients (or rendering any other brokerage service) is in a real-estate-related business — even if the brokerage time spent rendering services for others generates trade or business category income that must be separately reported from the broker's ownership of real estate rental properties.

However, sufficient time must be spent collectively in all related trades or businesses to qualify rental operating losses as an AGI adjustment.

Thus, for the landlord to offset business or investment income with his rental operating losses, he must annually spend a minimum amount of time rendering real estate services to others and for himself as follows:

Figure 2


Landlord with rental operating losses
Material participant as owner of real estate
or
500 hours annually in management decisions.
or
100 hours annually, but not less than any other co-owner or manager.
or
Substantially all management decisions.
or
Qualify during any 5 of the preceeding 10 years.
Owner/operator of real-estate-related trade or business.
Categories include real estate developed or services in:
• development
• construction
• acquisition
• conversion
• rentals
• operation
• management
• leasing
• brokerage
750 hours spent annually in all real-estate-related businesses (including landlording).
More than one half of time spent in all trade or businesses is spent in real-estate-related businesses (including landlording).
Rental operating loss is included in Adjusted Gross Income if an individual qualifies as both a material participant in rentals and an owner/operator or real-estate-related trade or business.

- more than **half of his time** in rendering services for his own account (landlording) or for others (brokerage) must be spent in real estate-related trades or businesses; and
- more than **750 hours of the entire year** must be spent in real-estate-related trades or businesses (a 15-hour weekly average). [IRC §469(c)(7)(B)]

To determine whether the individual spends sufficient time in real-estate-related trades or businesses, time spent in all his real estate-related trades or businesses is combined.

Time spent serving others

Consider a practicing doctor who is married and owns several rentals. The doctor averages 30 hours weekly as a physician and 15 hours weekly tending to his rental properties. His wife is uninvolved in the acquisition and management of the rentals.

While the doctor has an annual reportable income from his practice, the rentals are highly leveraged and produce an overall reportable operating loss.

Does the doctor qualify as an owner-operator of a *real-estate-related trade or business* to offset other income by the rental operating loss?

No! While the doctor spent 750 hours during the year (15 hours weekly) actively participating in a real-estate-related trade or business — his ownership of rentals — the amount of time spent as a landlord was not more than half of the total time spent tending to both his rentals and his patients, collectively called *services*. [IRC §469(c)(7)(B)]

Also, time spent by the doctor managing his investment portfolio (trust deed notes and land held for profit) does not qualify as professional services in a real-estate-related trade or business.

Now consider the practicing doctor who is married and owns several rentals that are community property. The doctor's *spouse* works more than 15 hours weekly acquiring and managing the rentals. The spouse has no other job.

Does the doctor qualify as an owner-operator in a real-estate-related trade or business because of the spouse's involvement in the rental activity?

Yes! For married couples filing jointly, one spouse can **separately satisfy** the requirements to **qualify the couple** as being owner-operators of a real-estate-related trade or business. [IRC §469(c)(7)(B)]

Here, the spouse spent sufficient time operating the couple's rentals to qualify the rentals as a real-estate-related trade or business. The spouse qualified by spending:

- more than 750 hours of the year in a real- estate-related trade or business (the ownership of rentals); and
- more than half of the total time providing services on a related trade or business (the rentals). [IRC §469(c)(7)(B)]

Thus, the combination of the couple's joint ownership and rental activity qualifies as a real-estate-related trade or business.

Editor's note — Time spent on the repair and maintenance of rentals cannot be used to qualify the owner as being in a real-estate-related trade or business.

Conversely, time spent on development, redevelopment, construction, reconstruction or conversion of a project does not constitute repair and maintenance, and thus qualifies the owner as having been involved in real-estate-related activities.

However, the qualifying spouse who is active in management must also demonstrate **material participation** as a landlord in the rental operations in order to use the couple's rental operating losses to offset other income.

The landlord's material participation

To qualify as a **material participant**, the managing spouse's time spent handling the rentals must meet one of the following criteria:

- exceed 500 hours annually (about 10 hours weekly);
- exceed 100 hours annually (about 2 hours weekly), but not be less than time spent by any other co-owner or manager;
- include substantially all management of the rentals; or
- the couple can qualify as a material participant in any one year if either spouse individually qualified during any five of the preceding 10 years. [Temporary Revenue Regulations §1.469-5T(a)]

The 500-hour landlord

Consider a real estate broker who works full time at his brokerage business and owns residential or non-residential rental properties as a co-owner with other investors.

The broker reviews and approves tenants and leases, and collects and deposits rents. He spends an average of 10 hours weekly managing the rentals. One of the investors spends more time than the broker does in the management of the rentals.

The rentals generate a reportable operating loss for the year, due to interest deductions, depreciation schedules and vacant units.

Can the broker write off his share of the rental operating loss to offset his brokerage income even though his co-owners are more involved than he is in management?

Yes! The broker qualifies as a material participant in his rentals since he spends more than 500 hours of the year on the management of the units. [Temp. Rev. Regs. §1.469-5T(a)(1)]

Thus, he is allowed to use his rental losses to offset his brokerage income and lower his AGI. The co-owner, for the same reason, also qualifies to write off his rental loss against other income.

The over-100-hour landlord

Now, consider a salesman who owns rentals and works 40 hours weekly as an agent for a real estate broker. The salesman's income is reported under his independent contractor status.

The salesman handles all aspects of management and operation of his rentals, and arranges for the maintenance and repair. He spends an average of six hours weekly on his rentals.

The salesman also employs an on-site resident manager who averages less than six hours a week deciding what repairs to make and which potential tenants qualify to lease.

Can the salesman write off his rental operating losses against his real estate sales income?

Yes, since:

- the salesman's real estate employment as an **independent contractor** to a broker qualifies as being in a real-estate-related business [IRC §469(c)(7)(C)]; and
- the salesman's landlording activities meet the standard for material participation since the salesman works more than 100 hours annually on his rentals and works more hours managing the rentals than any other individual. [Temp. Rev. Regs. §1.469-5T(a)(3)]

Editor's note — Brokers and salesmen who file as independent contractors qualify for the rental operating loss since both for tax purposes only are self-employed owners of a real estate-related business. [IRC §3508]

Now consider an owner of a vacation rental who hires a property manager, typically called a *vacation rental service*, to locate tenants, collect deposits and rents, hire cleaning services and maintenance staff, and prepare income and expense reports for the rental property.

The owner's activities connected to the rental include cleaning after each rental season, shopping, general maintenance, traveling to and from the rental, repainting the rental and painting artworks to hang on the walls.

The owner includes the operating loss in his AGI based on his participation in managing the rental property.

However, the Internal Revenue Service (IRS) disallows the loss claiming the owner's participation in management is not material.

Can the owner include the loss in his AGI based on his participation?

No! The owner's participation in the management does not exceed either the time spent by others who managed the property or 500 hours annually. [**Chapin** v. **Commissioner** TC Memo 1996-56]

Now consider the broker who owns a brokerage business and income- producing real estate. The broker works approximately 40 hours weekly on his brokerage business.

The broker's time spent on the management and maintenance of the duplex is relatively minimal, averaging approximately six hours monthly. The broker handles all aspects of the management and operation of the rental, except for the maintenance and repair of the units which he arranges to be done by a handyman.

The handyman works more hours monthly repairing and maintaining the rental than the broker does managing the rental.

Can the broker use the rental operating loss to offset other income from the brokerage business?

Yes! The broker can use the rental operating loss to offset other income as an adjustment to his AGI since the broker performs *substantially all* of the management of the units. The actual maintenance and repairs are not management activities. [Temp. Rev. Regs. §1.469-5T(a)(2)]

The time the broker spends managing the rental units is substantially all of the hours spent by all individuals making business decisions to manage the rentals.

The broker need not qualify under either the 500 or 100 hours spent annually acting as a material participant in the rentals since substantially all business decisions are made by the broker. [Temp. Rev. Regs. §1.469-5T(a)]

Five out of ten

Consider a developer who owns several rentals. In most years, the developer works an average of 25 hours weekly on his development projects and 15 hours weekly on his rentals.

The developer was qualified as a material participant in his rentals for the last four years, was not qualified for one year before that, and was qualified for the two years prior to that — a total of six out of the last ten years.

In the current year, sales of new houses were up. Consequently, the developer worked 40 hours (and more) weekly on his development business and hired a property manager to operate the rentals, leaving the developer only marginally involved in the rentals.

His development business showed a reportable income this year, but his rentals had a reportable operating loss.

Can the developer use his rental operating loss as an offset against his development income?

Yes! Although the developer is not a material participant in the day-to-day decision-making process of managing his rentals this year, he has qualified as a material participant in at least five of the last ten years. [Temp. Rev. Regs. §1.469-5T(a)(5)]

The mutually exclusive $25,000 deduction

To be passive category income, rentals need only be occupied by tenants for an average of more than 30 days. The over-30-day **occupancy rule** locks reporting of a property's income, expenses, interest and depreciation in the passive income category as rental income. [See IRS Form 1040, Schedule E]

Rental operating losses remaining after offsetting other rental and passive business income or profits can be deducted from the landlord's AGI up to $25,000 a year to establish the landlord's taxable income if, among other tests, the landlord qualifies as an active participant in his rental operations. To be "active" merely means primary responsibility for maintenance and management of the real estate remains with the landlord under the lease — even though an agent exclusively handles all the rental activities under a property management agreement.

The $25,000 rental operating loss deduction remains available if the landlord does not qualify as a *material participant* for the *rental operating loss adjustment* to the AGI. Obviously, the $25,000 loss deduction for the AGI will not be needed if the landlord qualifies his rental operating losses as an adjustment to establish his AGI.

Chapter 49 — Interest earned on §1031 monies

This chapter clarifies the seller's right to receive the interest earned on impounded §1031 funds.

Disqualification on early receipt

A seller of §1031 property has agreed to purchase replacement property on which improvements are under construction. The improvements will be completed in four or five months, at which time the seller will acquire title.

The seller is concerned about generating disposable income during the period after his sale closes, before taking ownership and possession of the replacement property. During the delay, the entire amount of net sales proceeds will remain on deposit with a §1031 trustee.

The real estate being sold has a large equity and generates a significant flow of spendable income. This income is the seller's primary monthly source of disposable income.

After the sale, the seller will not have sufficient income until he acquires ownership of the replacement real estate. The seller does not want to receive money from the net proceeds of the sale to carry him over until the replacement property is acquired. If he did, he would incur a 25% profit tax for unrecaptured gains (prior depreciation deductions) on the amount of money received from the sale, called *cash boot*.

However, the cash funds deposited with the §1031 trustee will **earn interest** in a savings account or certificate with a federally insured depository, such as a bank. The owner is entitled to all the earned interest by agreement, less reasonable §1031 trustee's fees for holding the funds.

May the seller receive the interest **as it accrues** on the net proceeds, prior to acquiring ownership of the replacement property?

No! While the seller is **entitled to the interest** earned on the funds held by the trustee, the interest cannot be disbursed to the seller until he receives all parcels of replacement property. If the interest is prematurely disbursed prior to taking ownership of all the replacement property the investor is to receive in his plan, the entire §1031 exemption will be denied. [Revenue Regulations §§1.1031(k)-1(g)(5), 1.1031(k)-1(g)(6)(iii)(A); see **first tuesday** Form 173-4 §3.2(c)]

Typically, the interest earned is included as funds held by the §1031 trustee, called the *corpus* or *trust estate*. On or after the date the last parcel of replacement property is acquired, the interest may be either withdrawn by disbursement to the seller by the §1031 trustee or disbursed by escrow from funds deposited into escrow for the purchase of the replacement property.

Thus, the periodic income needs and expectations of a seller in a delayed §1031 reinvestment may not be satisfied by prematurely receiving interest, an economic benefit of his net sales proceeds which he must wait to receive until the completion of his §1031 reinvestment plan.

Reporting interest income

Receipt by the seller of interest, paid by the depository (bank or thrift) holding the net proceeds from the sale, requires the seller to report the *interest as income*, separate from his §1031 reinvestment plan. Thus, the owner will pay taxes on the interest for the year in which the interest is credited to the trust account, regardless of whether the interest is ultimately disbursed to the owner in cash or used to purchase the replacement property.

However, the interest is not cash boot received from the sale of §1031 property since interest is not generated by the property. Instead, interest earned on the net proceeds and received by the seller is reported separate from the §1031 transaction as portfolio/investment income — even if the interest income is used to buy like-kind property. [Rev. Regs. §1.1031(k)-1(h)(2)]

Growth factors as disguised interest

Now consider a seller of timberland who intends to buy replacement property in a delayed §1031 reinvestment. A buyer is located, a purchase agreement and escrow instructions are entered into and, on closing, the timberland is conveyed to the buyer.

During the interim period after closing the sale until suitable replacement property is acquired, an annual *growth factor* accrues in the form of cash in an amount equal to 6% of the sales proceeds held by the §1031 trustee.

The growth factor is added to the net sales proceeds held by the §1031 trustee and is applied toward the down payment on the purchase of the replacement property. The seller reports the growth factor as part of his net proceeds and profit from the sale of his timberland.

On audit, the Internal Revenue Service (IRS) recharacterizes the growth factor as reportable interest income, taxable as *ordinary income*.

The seller claims the growth factor should be treated as profit, a capital gain exempt from taxation, and not interest income since the growth factor compensated the seller for the appreciation in value he would have enjoyed due to timber growth during the interim period had he not sold the property.

Here, the earnings labeled as a growth factor is interest and taxed as **investment category income**, not profit. The growth factor was not related to appreciation (or inflation) in the value of real estate since the seller no longer owned the property. Thus, the 6% earnings simply compensated the seller for the delay in his receipt and use of his net sales proceeds. Any compensation for the interim delay in the seller's use of money from his sale due to a delayed §1031 reinvestment is treated as interest, regardless of the label placed on the annual yield the seller receives. [**Starker** v. **United States** (9th Cir. 1979) 602 F2d 1341]

Limits on beneficial use of proceeds

One source of funds for the seller during the period of delay between closing escrow on the property sold and acquiring the replacement property would be to borrow funds from a bank to cover the seller's living expenses. The source of funds for repayment of the loan will be the interest the seller is to receive on taking ownership of a replacement property.

The seller must demonstrate to the lender he is entitled under the trust agreement to the interest which will be the source of repayment. However, his right to collect the interest may not be **assigned** or **pledged** to the lender as security for the loan. If the impounded funds are assigned, pledged or hypothecated in

any way, the seller will lose his entire §1031 exemption. The seller is considered to have **constructively received** the entire amount of the sales proceeds. [Rev. Regs. §1.1031(k)-1(f),(g)(6)]

Once assured that interest income is building up in the trust account and will be disbursed to the seller on acquiring a replacement property (or upon the running of the 180-day reinvestment period), a lender will likely make the seller a personal loan based on the seller's promises:

- to use the interest funds as the primary source of repayment; and
- not to sell or collateralize the right to receive the interest.

While it is impermissible conduct in a §1031 transaction to give the lender a lien on the trust funds to secure repayment of a loan taken out by the seller, the existence of *compensating balances* with the bank, as the depository holding the trust account funds, is a common inducement offered to a bank to make a loan, and no lien or offset rights of any type would exist for the bank.

Chapter 50 — Home office tax deductions

This chapter illustrates the home office brokerage activities needed to establish the home office as a "principal place of business" for tax deductions.

The expenses and uses that qualify

Real estate licensees who work out of their homes, whether they rent or own, can qualify to deduct expenses related to the carrying costs and maintenance of the home office from their brokerage income.

To qualify for the home office deduction:

- a portion of the home office must be used *exclusively* and *regularly* for the licensee's brokerage business;
- the expenses must be *direct or indirect*; and
- the use of the home office must meet one of three *business activity standards*.

Broker and salesman

Taxwise, real estate brokers and salesmen both report themselves as self-employed, also called *independent contractors*, if:

- they are licensed as a broker or salesman;
- substantially all compensation received is based on sales or other brokerage production, called *contingency fees*, rather than an hourly wage; and
- a salesman has a written agreement with a broker stating the salesman is considered an independent contractor for income tax purposes. [Internal Revenue Code §3508(b)(1)]

Brokers and independent contractor (IC) salesmen qualify for the home office deduction under the same rules. If the licensee qualifies for the home office deduction, the deductible home office expenses include:

- the *direct expenses* attributable to the home office area used exclusively in the business; and
- the *indirect expenses* which are limited to the percentage of the residence used for the home office.

Direct expenses

Direct expenses, deductible as a brokerage business expense, include the cost of decorating and repairs in the portion of the residence exclusively used as the home office.

The entire amount of direct expenses is deductible from business income without any allocation of the expenses toward the personal use of the residence.

Indirect expenses

Indirect expenses are costs incurred in the upkeep and operation of the licensee's residence, including:

- rent paid as a tenant;
- mortgage interest;

- real estate taxes;
- home insurance;
- utilities; and
- maintenance. [Proposed Revenue Regulations §1.280A-2(i)(5)]

The portion of indirect expenses deductible as a business expense is equal to the percentage of the residence used as the home office.

For example, a licensee exclusively uses 300 square feet of his residence as his home office. The total area of the residence is 1800 square feet. Thus, the broker's home office is 16.7% of the total square footage of the residence.

The broker's indirect expenses — incurred as ownership and operating expenses on the entire residence — include:

- $15,000 in mortgage interest;
- $2,000 in real estate taxes;
- $3,600 in utility payments; and
- $900 in insurance costs;
- for a total of $21,500.

The licensee may write off $3,590.50 as indirect business expenses, which is 16.7% of the residence expenses. [Prop. Rev. Regs. §1.280A-2(i)(7)]

In lieu of ownership expenses, a tenant using a home or apartment for his office may write off a pro rata amount of the rent as a business expense. [**Visin** v. **Commissioner** (2003) 86 TCM 279]

The licensee also spent $1,200 for pool and landscape maintenance, $2,500 to remodel the kitchen and $500 for maintenance of a bathroom not located within the home office area. However, no portion of these expenses is deductible since they are unrelated to the business use of the home.

Expenses outside of the dwelling incurred for lawn care, pool maintenance or tree trimming cannot be deducted as business expenses. Further, expenses incurred on the inside of the house which are unrelated to the home office area are not deductible, such as the remodeling or maintenance of any area other than the home office area. [Prop. Rev. Regs. §1.280A-2(i)(7)]

If the licensee paints and carpets the home office area, the entire cost of painting and carpeting the home office area is deductible as an expense directly related to the home office.

However, before the licensee can deduct any of the home office costs as business expenses, the home office area must be used exclusively and regularly for the licensee's business.

Exclusive use

Consider the licensee who uses his family room as a home office. His family also uses the family room to watch TV and occasionally entertain guests on evenings and weekends.

Thus, the area in the licensee's residence set aside for the home office is not used exclusively for the brokerage business. Since personal use of the area occurs during after-office hours, no home office deduction is allowed. [IRC §280A(c)(1)]

While a room or two, and possibly an extra bathroom, often serve as the home office, the area need not be cordoned off or partitioned to qualify for exclusive use. [**Weissman** v. **Commissioner of Internal Revenue** (2nd Cir. 1984) 751 F2d 512]

In addition to the home office area being dedicated exclusively to business activities, the home office must also be used regularly by the licensee in conducting his business.

Regular use

Consider the licensee who maintains both a home office and an office in a nonresidential building. He works each day and keeps his files, conducts most of his real estate sales business and is assisted by a part-time secretary at the nonresidential office.

However, the licensee uses the home office four or five days each month in the evening to catch up on work he was unable to complete at the nonresidential office, such as reading real estate journals and studying to earn his continuing education credits for his license renewal.

Here, no deduction can be taken for home office expenses. The area used as the home office is not used regularly in the course of the licensee's business.

If the licensee meets the exclusive and regular use test, the home office must further qualify to take the allowable deduction under one of three standards of business conduct.

Qualifying uses

To meet the final qualification for the deduction of home office expenses as a business expense, the licensee must establish he conducts business at the home office under one of the following tests:

- the home office is used as a place of business to meet or confer with clients;
- the home office is located in a separate structure not attached to the residence; or
- the home office is the principal place of business for the licensee. [IRC §280A(c)(1)(A-C)]

If the broker or IC salesman uses the home office to **regularly meet** and confer with clients, the deduction of home office expenses from brokerage income is allowed. The licensee should document the client conferences by keeping a calendar or log book showing the names of his clients, the date he met with these clients at his home office, and what they discussed or acted upon.

Also qualified for the deduction of business expenses is the home office of a broker or IC salesman located in a **structure separate** from the licensee's residence. Examples include a detached garage apartment or outbuilding, the deduction being allowed for the building's separate business use.

If the licensee does not use the home office to meet or confer with clients, or the home office is not located in a separate structure, the licensee will need to demonstrate the home office is his principal place of business to qualify for the home office deduction.

Principal place of business

To qualify for the deduction of home office expenses, the licensee must perform the most important activities in the course of his business while working in the home office.

However, it is atypical for a real estate broker or IC salesman to spend all of his working hours of the business day or to perform all of his business activities at his office, no matter its location.

Typically, real estate brokers and agents, in the course of conducting a real estate brokerage business, use their office to:

- prepare agreements, disclosure documents and advertising copy;
- organize and schedule brokerage activities; and
- regroup after collecting information, investigating property and records, and meeting with others in the course of the business.

Thus, the question arises as to which place, among the locations used by the licensee to perform any business-related services, is the location of his principal place of business.

The location of the principal place of business is determined by a comparative analysis of the importance and significance of the real estate services performed by the licensee at various locations.

For doctors, the treatment of patients is the most important aspect of their practice. Thus, the location where the treatment is given is a doctor's principal place of business, which may be in a laboratory, hospital or care center. [**Soliman** v. **Commissioner of Internal Revenue** (1993) 506 US 168]

Accordingly, for criminal lawyers, if the representation of jailed clients is the entire practice, the location of the principal place of business may well be the court house or the county law library, where the services of defending the client and researching the legal aspects of the client's case occur.

Consider the self-employed broker or IC salesman who has no other office but his home office, and is claiming a home office deduction.

The licensee's phone calls to clients and others in scheduling and performing his brokerage services are made from the home office. All listing agreements, purchase agreements, other contracts and disclosure documents are reviewed and prepared at the home office. All of the licensee's records and files plus his word processor, fax machine and office equipment are located in the home office.

Clients are not met at the licensee's home office but at the client's office or residence, at restaurants, or at the location of the real estate involved. Personal meetings with clients are to review documents, conditions of the property (physical, title, operations, location and disclosure), and the status of the transaction, and also to obtain signatures.

Other business activities outside the home office include previewing property, attending marketing sessions and multiple listing service (MLS) presentations, and meeting with title officers, escrow officers, attorneys and accountants representing clients, lenders, home inspectors, property management and maintenance services and government agencies.

Does the licensee qualify to deduct his home office expenses as expenses incurred at his principal place of business?

Yes! The home office deduction will be allowed. The most important aspects of a brokerage practice are soliciting and coordinating client contacts, preparing agreements and disclosure statements, and maintaining files and records, all of which were performed in the home office.

Obtaining signatures on documents, inspecting property and meeting with others at locations outside the home office are essential, but not the most important aspects of the licensee's business.

Signatures are either:

- an authorization to perform all the services required to achieve the client's objectives — the sale or purchase of property, securing or placing a tenant or the arrangement of a loan; or
- the culmination of the licensee's diligence prior to an offer, acceptance or counteroffer.

Property inspections are fact-gathering expeditions to compile data on a property's condition, which is later documented in disclosure statements prepared and maintained at the home office. Although essential, the actual inspection of property is not an event licensees perform in any office.

Two offices — one for the public

The licensee with both a home office and a nonresidential office can still qualify for the deduction of home office expenses.

Consider the broker or IC salesman who maintains desk space in a small downtown office with several other licensees, sometimes called a "cubby." The licensees using the downtown office share its maintenance and operating costs, such as employing a receptionist, contributing rent, and paying for janitorial services and utilities for the premises.

Each licensee pays a pro rata share of the costs based on his actual share of the space he uses. The office merely provides the broker or IC salesman with a "public" business address, a more professional place for meeting clients than coffee shops or the client's offices or residences.

All of the licensee's phone solicitations and contacts with clients and others while performing his brokerage services are made from the home office. All agreements and disclosure forms are prepared at the home office, and all his records, files and office equipment are located at the home office.

Appointments to meet with clients or real estate affiliates or to show property are made from the home office. He only uses the downtown office as a "window" where he meets clients to show property, confer with them in person and obtain their signatures on documents.

Here, the licensee qualifies to deduct expenses incurred at his home office from his business income. The use of the home office establishes it as his principal place of business.

Even though he has a nonresidential office for professional reasons, the most important part of his work (soliciting, conferring and packaging transactions) takes place at the home office.

Two offices — main office downtown

Now consider the broker or IC salesman who makes more substantial use of his nonresidential office.

The licensee maintains an office downtown which he uses daily to solicit, make appointments with and meet clients. He also arranges property inspections, escrows, and title information and prepares agreements and disclosures from the downtown office.

The licensee's home office is used to do his bookkeeping, maintain his real estate library and study. He occasionally phones clients, receives calls and reviews documents at his home office. He spends one or two hours most evenings working in the home office.

Here, the broker or IC salesman's use of the home office is insufficient to qualify for the home office deduction.

The licensee's most important activities — client contacts in person and by phone, packaging deals and preparing agreements — take place largely at the downtown office.

While the bookkeeping and studying at the home office may well be essential to the licensee's ability to continue conducting a brokerage business, they are not the most important part of the licensee's business. It is the rendering of services in the practice of real estate brokerage on behalf of clients that is most important — and these services did not occur at the home office.

Salesmen and the home office

Although brokers generally work for themselves, salesmen always work as employees of a broker and typically maintain a desk in their broker's offices. However, the broker's employment and supervision of the salesman, as mandated by state law, will not limit the ability of the salesman to qualify for the home office deduction.

Taxwise, a salesman must first qualify as an independent contractor with his broker before he can deduct home office expenses.

A salesman's independent contractor tax status is established by a written employment agreement between the salesman and the broker stating the salesman is considered an independent contractor and will pay his own income taxes without the broker withholding. Nothing more is required. [See **first tuesday** Form 506]

For example, a real estate salesman is given a desk in his broker's office. The salesman uses the office to meet clients and prospective buyers before taking them to look at real estate. Occasionally, he meets clients at the real estate involved instead of at the office. The office is used to review active files with his broker as his supervisor once each month.

The salesman also has a home office, where he maintains a business phone line to solicit and confer with clients and to contact real estate affiliates regarding property and transactions under his care. He also prepares agreements and maintains all his records and office equipment at his home office.

Here, the salesman qualifies to deduct the expenses incurred in maintaining the home office, even though he works for a broker and has desk space in the broker's office.

The salesman uses his desk at the broker's office as a window to meet his clients. His meetings with the broker are administrative, not part of the services rendered to clients, since the broker is responsible for supervising the salesman's conduct and file maintenance.

However, the most important tasks of the salesman's real estate practice are the preparation of documents and the scheduling of meetings and phone conferences with clients and customers, which take place at the home office.

Limitations on deductions

A real estate sales agent uses his residence as his principal place of business. Annually, he writes off his home office expenses against his sales income.

During the past tax year, the agent's earnings were small, resulting in a net business loss for the year.

However, home office deductions are limited if they create or increase a net loss for a business. [**King** v. **Commissioner** TC Memo 1996-231]

Chapter 51 Tax partners or independent co-owners

This chapter presents the arrangements co-owners of fractional interests in a real estate investment must undertake to qualify a fractional ownership interest as a §1031 property.

§1031 fractional ownerships

For the profit taken on the sale or exchange of an interest in real estate to be exempt from taxes under Internal Revenue Code (IRC) §1031, the interest sold or exchanged must be an **ownership** which qualifies as *like-kind property*, commonly called §1031 property. So too must the ownership acquired in the replacement real estate be §1031 property.

In any §1031 reinvestment plan, both "legs" of the plan, namely the property sold and the property acquired, must qualify as the investor's **ownership** of §1031 property. Section 1031 property is property held either for **investment** or **productive use** in a business. [Internal Revenue Code §1031]

Consider the sale or acquisition of a **fractional ownership interest** in income-producing real estate co-owned by two or more investors for investment under each of the following four scenarios:

1. An investor joins with one or more other investors, all of whom **contribute cash** to jointly acquire income-producing real estate.
2. An investor sells his ownership interest in §1031 property producing **§1031 money** which he **reinvests** either by, 1) joining with one or more other investors to pool funds and acquire income-producing real estate, or, 2) buying a fractional interest from a co-owner in a property presently owned by a group of investors.
3. An investor **sells his fractional ownership** interest in income-producing real estate, while the other co-owners remain in ownership of the property, and **reinvests** his net sales proceeds by acquiring the sole ownership of §1031 property.
4. An income-producing property co-owned by two or more investors is sold and one co-owner **withdraws** his share of the net sales proceeds and **reinvests** the funds independently of the other co-owners by acquiring sole ownership of like-kind property.

In each example, co-owners joined together to buy, own or sell a property held or to be held for investment. Also, the parcel of real estate bought or sold in each of these examples is itself managed and operated as §1031 property. Thus, the real estate **qualifies its group ownership** (the group) for a §1031 exemption on the sale of the entire parcel, regardless of whether the ownership of the real estate is a limited partnership (LP), limited liability company (LLC), common law tenants in common (TIC), tax partnership, corporation or sole ownership.

However, a fractional ownership interest sold or acquired by an investor does not qualify as §1031 property if the interest is a **co-ownership interest** in an entity, such as an LP, LLC, corporation or other co-ownership arrangement calling for the alienation of the property or fractional interest by less than unanimous consent. It is the entity which owns the real estate. An investor's reinvestment plan does not qualify for the §1031 exemption when the plan includes the sale or purchase of a fractional ownership interest in an entity. [See Scenarios 2, 3 and 4, *ante*]

Taxwise, a co-owner vested as a tenant-in-common with a group of co-owners is considered a *tax partner* in the co-ownership of §1031 property if he has **agreed to restraints** on his common law rights as

a tenant-in-common to freely manage his interest in the property, independent of control by other co-owners and as he sees fit.

Once classified as a **tax partner** for income tax reporting, the tenant-in-common investor is considered a co-owner of an interest in a *tax partnership*, not a co-owner holding an ownership interest in the real estate. As a result, the tax partnership is treated for tax purposes only as the sole owner of the §1031 property, since the tenants in common are now partners who only own the partnership.

When a tenant-in-common co-owner, by agreement or by definition, is a *tax partner* with others in each of the four scenarios given above, then none of the profit taken on the sales leg qualifies as exempt from taxes. Both the sales and purchase legs of a §1031 plan must manifest the attributes of an ownership interest directly in the real estate, not the investor's mere ownership of an interest in a partnership. A partnership operates independently of each tenant-in-common to **control the ownership rights** of all co-owners.

A tax partnership vs. a California partnership

The **coordinated conduct** of co-owners in the exercise of *ownership rights* to operate the investment real estate they co-own is viewed differently under federal income tax law than under California partnership law.

Basically, if co-owners **share** the income, profit and losses generated by a joint investment in real estate operating under an unincorporated ownership arrangement, California partnership law, which broadly defines a partnership, classifies the profit-sharing group as a partnership. Thus, California imposes *agency obligations* on each co-owner to act in concert for the mutual benefit of the group from the moment of first discussions about a syndicated investment. Thus, anarchy within the group of co-owners is legally avoided as public policy.

Conversely, federal tax law places emphasis on TIC law to establish co-owner rights. Tenant-in-common ownership does not rise to tax partner status unless the co-owners are operating as a declared partnership, LLC or cooperating TICs.

To avoid tax partnership status, each co-owner vested as a tenant-in-common must have the unrestricted common law right to independently *alienate* his fractional interest without the prior consent of other co-owners. Further, each co-owner must have the unrestricted right to independently block any *alienation* of the entire property co-owned by the group.

Alienation of the entire property refers to its sale, further encumbrance or a lease for a period exceeding one year.

Taxwise, the ownership of a TIC interest which retains its common law right of alienation in real estate is viewed as being the ownership of a fractional interest in the real estate itself. Thus, the tenant-in-common is not the owner of an interest in a partnership that actually owns the property.

Further, TIC co-ownership arrangements may provide for **cooperation among the co-owners** in the ongoing management and operation of the property. Operating the property by *centralizing management* does not violate the requirement of unanimous approval for alienation of property owned by common law TICS. Thus, the alienation rights inherent in ownership are distinguished from the day-to-day operations of the property.

An understanding of the distinctions between federal tax law, which defines §1031 property investments as excluding fractional interests held by *tax partners*, and California's partnership law, which controls joint ventures and profit sharing ownerships, is helpful to all individuals involved in investment groups, such as:

- **syndicators** structuring the ownership for acquisition of property by an investment group they are forming;
- **investors** acquiring or withdrawing a fractional interest from a syndicated real estate investment; and
- **brokers** (or other advisors) representing a person who is buying into or withdrawing from a real estate syndicated investment.

Knowing the parameters for activities that establish a partner under California partnership law versus activities that establish a tax partnership for federal income tax reporting avoids unintended and unexpected results under either set of laws, or worse, the loss of a transaction because of insufficient knowledge to explain the distinctions to clients, their advisors and others.

Accordingly, this chapter contains an analysis and application of the overlapping partnership laws controlling the syndication of real estate investments (state law) and the exemption of profits from taxes (federal law) on a sale or purchase with §1031 money of a fractional interest in a syndicated investment.

We cooperate in California

A group of investors acquire income-producing property located in California. Title is taken as **tenants in common**, naming each investor and stating his percentage or fractional share of *undivided ownership* in the property. The property is occupied by tenants under short-term leases and periodic rental agreements which provide for the landlord to care for and maintain the premises.

The co-owners orally agree:

- to divide annual operating income (or losses) and resale profits pro rata based on their percentage of ownership;
- to hire the broker who organized the group to manage the property with authority to locate tenants, enter into short-term lease and rental agreements, collect rents, contract for the repair, maintenance, utilities and security to be provided by the landlord under the lease agreements, pay operating expenses and mortgage payments, and distribute spendable income to the co-owners quarterly;
- to grant each other a right of first refusal on a resale of their fractional TIC interest; and
- to grant the syndicator the option to purchase the property at its fair market value.

Are the co-owners conducting themselves as partners under California partnership law despite the tenancy in common vesting placing each co-owner on title?

Yes! Co-owners of California real estate vested as tenants in common, when engaged in the business of jointly operating the property on terms calling for them to **share income and profits**, are conducting themselves as partners. Thus, they are considered agents of one another, charged as a fiduciary with the duty **to cooperate in the ownership** of the property. [Calif. Corporations Code §§16202(a), 16202(c)(3)]

A tenancy in common vesting does not control the **possessory rights** of the co-owners when the co-ownership in fact constitutes a state law partnership. For example, a partner may use or possess partnership

property only on behalf of the partnership, while a tenant-in-common (at common law) may use, possess or lease the property himself. [Corp C §16401(g)]

Further, tenants in common who conduct themselves as *joint operators* of a property, such as occurs with a rental property, are not co-owners of the real estate. They are partners who co-own their partnership. Thus, the partnership owns the property without concern for the type of vesting the group of investors has chosen. As a partner, the vested co-owner holds no right to a possessory interest in the property which he can independently possess or separately transfer by leasing the property to a tenant without concern for the other co-owners.

The only *transferable interest* the tenant-in-common owns is his **fractional interest in the partnership**. The partnership interest entitles him to share profits and receive distributions. Thus, the co-owner's fractional interest, vested as a tenant-in-common, is no more than a **personal property** share of ownership in a California partnership. [Corp C §16502]

Trustees for one another by law

Although title to the income-producing property held by the co-owners for profit is vested in the names of all the co-owners, each co-owner actually **holds title as a trustee** on behalf of all the tenants in common, collectively called a *partnership*. [Calif. Civil Code §682; Corp C §16404(b)(1)]

As co-owners and operators of a rental property, they have formed a partnership, holding title in the most troublesome of all California co-ownership vestings: tenants in common, a TIC.

Thus, the conveyance of a co-owner's TIC interest to another person conveys nothing more than the co-owner's interest in the partnership's *equitable ownership* of the property. The partnership's title to the property is **held in trust**, in the name of each co-owner for the benefit of all co-owners.

The defining acts of partners

Prior to California's 1949 enactment creating *tenancies in partnership*, tenants in common who owned rental property that required centralized management did not constitute a partnership. No *agency relationship* existed between tenants in common before 1949 to protect the common interests of the co-owners to share profits. The federal tax law defining TIC interests remains the same today. [**Johnston** v. **Kitchin** (1928) 203 C 766]

Since 1949, a California partnership exists when two or more co-owners join together to carry on a business for income and profit in California. A California business includes every trade, occupation or profession. [Corp C §16101(1)]

While landlording is not a trade or business category activity for federal income tax purposes (as the property is a passive rental operation or a portfolio asset), landlording by a syndicated group is an occupation under California partnership law. A co-ownership is a California partnership if the co-owners are involved in **sharing earnings and profits** from rental operations, refinancing and resale of the property they own. [Corp C §§16202(a), 16202(c)(3)]

Also, the receipt of income (from operations) and profits (from a sale) by co-owners from their joint investment is considered evidence of a California partnership, unless the earnings are received by a co-owner in payment:

- of an installment note, including one given in consideration for the sale of goodwill or property;
- for wages or rent due the co-owner;

- on an annuity to a surviving spouse, representative or a deceased co-owner; or
- as interest on a loan. [Corp C §16202(c)(3)]

The tenancy-in-common partnership

With a tenancy-in-common vesting, the sharing of income and profits earned by each co-owner's **separate use** of the property — such as occurs with the extraction of minerals from the property by each co-owner for their own separate use — does not in itself create a California partnership. It takes more than the sharing of use and possession by co-owners to constitute conduct on the level of a partnership. [Corp C §16202(c)(1)]

It is the interaction and **coordinated conduct** of the co-owners while directly or indirectly managing or operating the investment that determines whether a state law partnership relationship exists between them. Once the conduct of co-owners in a coordinated ongoing operation of the property constitutes a **joint and mutually beneficial activity**, an agency relationship exists between the co-owners.

With the agency relationship comes *fiduciary duties* owed to partners which obligates each prospective or actual co-owner to **act in the best interest** of the group, not to act independently on the investment opportunity before them. [Corp C §16404; **Leff** v. **Gunter** (1983) 33 C3d 508]

Thus, co-owners of rental property who are vested as tenants in common and who **act collectively** to manage the property or authorize a property manager to operate the property on their behalf, hold ownership to the real estate under what has been best entitled a *tenancy in partnership*, each co-owner being a tenant in partnership with all other co-owners.

By the *sharing of income* among co-owners who are vested as tenants in common, a **tenancy in common partnership** is established, subjecting each co-owner to the rights and obligations of a partner, such as:

- the duty to hold title to the real estate as a trustee for the benefit of the partnership [Corp C §16404(a)(1)];
- the right of each co-owner to use and possess the real estate — but only for group purposes [Corp C §16401(g)];
- the right to use and possess the real estate is nontransferable unless all co-owners **collectively transfer** the partnership's right to possession of the property [Corp C §§16203, 16501]; and
- the property co-owned by the group is not subject to *attachment or execution* on a judgment against an individual co-owner, only on claims against the partnership. [Corp C §§16201, 16501]

Even when co-owners do not characterize their mutual working relationship in a profit-sharing investment as a partnership, they are still obligated to act on behalf of the group as though they were partners in a partnership. [Corp C §16202(a)]

Under state law tenant-in-common co-owners hold no interest in the real estate they co-own which they can legally transfer, voluntarily or involuntarily, independent of the rights of the resulting California partnership. [Corp C §16502]

However, federal tax law for determining tax partner status of TICs excludes the results of state laws to the contrary. [Revenue Procedure 2002-22]

A tax partner's profits disqualified

The penalty for a tenant-in-common co-owner who is federally classified as a *tax partner* in the ownership of either the property sold or the property acquired in a §1031 reinvestment plan is the loss of the entire §1031 tax exemption for profit taken on the property sold.

Thus, just what arrangements or activities a co-owner, other co-owners, a property manager, syndicator or lender agree to between themselves which would make a co-owner a tax partner is or may become of great concern to investors in syndicated real estate investments programs.

When a co-owner of investment real estate is classified by the IRC as a **partner**, the real estate is considered to be owned by a *tax partnership*. Classified as a partner, the co- owner's ownership interest is that of a share in a partnership that **does not qualify** as §1031 property.

To avoid tax partner status, a co-owner in a real estate investment does not want to be financially coupled with a co-owner or manager who provides the tenants with services which are **unrelated to the operation** of the property.

Thus, an investor with after-tax cash he has accumulated, or §1031 money to reinvest, who makes a *capital contribution* to a group being formed to jointly own and operate an income-producing parcel of real estate must be assured no co-owner is sharing in any income from tenants other than rent. Co-owners who occasionally provide tenants with business or professional services for a fee separate from rent, or share in the income received by others providing services to tenants which go beyond the **customary services** required under a lease, establish tax partner status.

Co-owners or partners

Tax partner status is of no concern to an investor, unless and until the investor:

- withdraws from a group to separately invest on his own; or
- desires to exchange his sole ownership in real estate (or the cash from its sale) for a fractional ownership in a replacement property.

To get a mental grip on the **federal distinction** between a co-owner's non-partner status and tax partner status in the co-ownership of an investment in real estate, it is instructive to know the purposes behind the different income categories established to report and account for income, profits and losses from the ownership and sale of real estate.

Three income categories have been established for reporting income. The source or nature of the income, profit or loss determines the income category in which the income, profit or loss will be reported, such as:

- *trade or business income category*, which includes real estate occupied and used in the business owned and operated by the person who owns or co-owns the real estate, including residential housing with an average occupancy of less than 30 days, such as motels, hotels, vacation rentals and other transient housing and boarding facilities that provide occupants with services unrelated to the care and maintenance of the property;
- *passive income category*, which includes residential and nonresidential rental properties with an average occupancy of 30 days or more, but with a tenancy less than a triple net (master or ground) lease, providing the resident with, by the lease or rental agreements, the repair, maintenance, security, utilities and management typically included in exchange for rent under lease and rental agreements or as required by state law; and

- *portfolio income category*, which includes income-producing real estate subject to long-term lease agreements which shift the responsibility for the care, maintenance, repair and operation of the property and the payment of expenses of ownership such as property taxes, assessments and insurance premiums to the tenant (as in a master lease, ground lease or other type of management-free triple-net lease), and includes other like-type flows of management-free income such as bonds, stocks, interest on loans (trust deed investments) and vacant, unimproved real estate held for profit on a resale (not as dealer property).

Thus, income-producing real estate *held for investment* and leased to tenants is classified as either:

- rental (passive income) property requiring **management services** related to the tenancies; or
- portfolio income property requiring very little or no **tenant-related services** to be provided by management.

Land held for investment requiring no management services, except for the annual payment of taxes, assessments, insurance premiums and the like, is classified as portfolio property. However, land held for development, subdivision and resale by the owner or a co- owner is trade or business category inventory.

Stated another way, rental (passive income) property and portfolio income property are not business property. On the other hand, a motel or hotel is a business property since services unrelated to rental property operations are provided.

And as a further distinction, the co-ownership arrangements relating to the management of rental or portfolio properties consists of services customarily provided for tenants by a landlord, directly or through an agent. The **landlord's services** provided for tenants are not business-related services, such as maid services, food, laundry pickup and delivery and towels and linens, which are provided to more transient occupants of trade or business category property, such as hotels, motels, transient housing or vacation rentals.

Thus, negotiations with prospective tenants to lease units or space within the property, limited to providing customary landlord services, such as the collection of rent, evictions, repairs and maintenance of the property, utilities, security and other real estate-related services typically included in the rent, is not a business. Obviously, the property is not a business income category asset which provides **business-related service**, as an operator of a hotel, motel, boarding house or vacation rental property does.

Without being coupled to a business service, the capital contribution of a co-owner and landlord services the co-owner provides in the form of rental property operations for the care and operation of the property as a rental or portfolio asset, does not make the co-owner a tax partner. None of the co-owners are involved rendering *additional services* to the tenants through a business, enterprise or joint venture in which one or more of the co-owners share profits or losses in trade or business services offered to tenants.

A property manager and his authority

Co-owners can join together to own and operate income-producing property and will not be considered tax partners when they hire a broker (who may be a co-owner) as an independent property manager. The manager may be given all the authority he needs to do all acts necessary to provide for tenants under standard leasing arrangements.

However, the manager may not be given the authority to enter into long-term leases, sell or encumber the property. These are the rights of *alienation* held by each co-owner which must remain unrestrained and require unanimous approval by all co-owners to be exercised.

The authority co-owners may give a property manager without becoming tax partners is extensive, and includes the authority to:

- act on behalf of the co-owners to negotiate and enter into leases and rental agreements with prospective or current tenants;
- collect deposits, rents and other amounts due from tenants and deposit them into a common bank account maintained for (but not in the name of) the co-owners;
- contract for all services customarily provided to tenants under similar circumstances as part of the rent, including normal repair and maintenance of the property, utilities, garbage/trash pickup, a resident manager and security;
- pay from rents (and additional funding by co-owners made necessary due to insufficient rental income) the charges for all services the manager contracts for as authorized, including the payment of property taxes, assessments, insurance premiums, mortgage payments and management fees;
- disburse to the co-owners no less than quarterly their share of spendable income; and
- prepare annual statements for each co-owner setting forth his share of income, expenses, interest and depreciation. [IRS Revenue Ruling 75-374]

Thus, co-owners are merely limited to the classic relationship between a property manager and an owner of income-producing property. No co-owner, directly or indirectly through another person, will carry on or share profits in a trade or business which will provide additional services to the tenants beyond those customarily provided under common leasing arrangements in exchange for rent.

However, each co-owner will be considered a tax partner who is carrying on a trade or business, financial operation or venture in a tax partnership if he is:

- any co-owner renders the additional **business-related service** to tenants; or
- the property manager renders the additional business services and one or more co-owners **share in the income** the manager receives for providing the business-related service to the tenant.

Thus, the **tax partnership** includes the person rendering the business-related services whose income for those services provided is shared with one or more of the co-owners of the real estate. It does not matter that the person rendering the services (such as the property manager) may have no claim to the spendable income from the rental operation, proceeds from a refinance or net proceeds from its resale.

The property manager hired by the co-owners may not be a tenant and must be on a short-term management agreement not to exceed one year. The management agreement may only be extended or renewed for a period not to exceed one year by a unanimous vote of the co-owners (or by a failure to vote). The property manager's pay must be comparable to fees paid brokers in the area for managing similar properties and providing similar management services.

While the manager may not be a tenant, a long-term lease, pre-existing or unanimously agreed to by all the co-owners, could provide for a **lessee** to care for, operate and incur at his expense all the typical services (sub)tenants may need to occupy the premises, including the right to sublet the property, an arrangement called a *master lease*.

Also, the property manager may be granted an option to purchase the property. However, the price to be paid for the property on exercise of the option must be set as the **fair market value** of the property at the time of purchase.

The devolution of TIC control

Some flexibility exists regarding the annual unanimous consent of the tenant-in-common co-owners to the renewal of property management agreements and the extent of authority which may be granted to management to enter into long-term leases of portions of the property. [IRS Private Letter Ruling 2005-13010]

Each long-term lease must be unanimously approved by all tenant-in-common co-owners to qualify each individually owned fractional ownership interest as §1031 property. This unanimous approval may be satisfied by an **annual unanimous approval** of a set of leasing guidelines for management. Management would then follow the guidelines in the exercise of the leasing authority given management in the property management agreement.

Thus, the authority given in the leasing guidelines is viewed as a method by which each tenant-in-common co-owner retains direct control over his right to disapprove a proposed lease. The parameters set in the guidelines place a limit on management's flexibility in the discretionary leasing of the property.

The Internal Revenue Service example for leasing guidelines include the typical standards any landlord sets for qualifying prospective tenants and structuring the terms and conditions of lease provisions. Guidelines for leasing include the tenant's and landlord's obligation to care for and maintain the property, selection of the type of tenants, tenant creditworthiness, a range of rent amounts to charge tenants, the term of the lease and the content of lease provisions.

Interestingly, the syndicator managing the property is allowed, as outlined in the IRS letter ruling, to bar any tenant-in-common co- owner from altering the guidelines during the year following their approval since the unilateral change would be less than unanimous approval. Until the next annual approval of leasing guidelines occurs, each tenant-in-common co-owner agrees not to alter the guidelines by exercising his ownership rights to lease the property, himself or through a competitive leasing agent, on conflicting, and possibly more advantageous, long-term arrangements. [PLR 2005-13010]

Also, while the requirement for unanimous annual approval of the property management agreement is an anarchic condition detrimental to current management, apparently automatic one-year approval by **mere silence** at the time of the annual renewal of the management agreement is deemed a sufficient exercise of a tenant-in-common co-owner's right to approve or disapprove annual contracts with management.

For example, a TIC operating agreement entered into by all tenant-in-common co-owners calls for **automatic annual renewal** of the property management agreement. Should all tenant-in-common co-owners **fail to object** to any provisions submitted by the management team in a *notice of renewal* of the management agreement, management has been approved for another year — by silence. Thus, a tenant-in-common co-owner exercises his right to control his interest in the property by objecting. However, if he does object he will be penalized.

The conduct of management permitted in the letter ruling gives co-owners who agree with management the right to buy out the objecting co-owner's interest. If not bought out, the objecting co-owner is limited to hiring his own property manager. However, for doing so, he will alone bear the cost of his manager. Further, his manager will only be an advisor to the current management, unable to exercise any objection he or his employing co-owner may have. Could management have it any better? You bet they can!

As a final detriment for objections to the current management's unaltered or continued involvement, a co-owner's objection triggers an option for a buy out of the objecting co-owner's TIC interest (without a corresponding option to buy out his non-objecting co-owners' interests if they do not purchase his interest). The option price to be paid for the objecting co-owner's TIC interest is his fractional portion of the property's fair market value (set by an appraiser chosen by a majority vote of tenant-in-common co-owners). The buy out provision places a co-owner at risk of a loss on his investment if he should object to the renewal.

Normally, a co-owner objecting to management has a reasonable basis for doing so, namely that management procedures and policies are deteriorating the future worth of the property and new management to take corrective action to preserve and build up equity in the property.

Hence, the property's present fair market value at the time of a co-owner's objection, especially in syndicated property which attracted §1031 monies, is an amount less than the price paid by the group to acquire the property (usually from the syndicator or a related entity) since poor management has deteriorated its worth.

Accordingly, if the non-objecting tenant-in-common co-owners exercise their option to purchase the objecting tenant-in-common co-owner's co-ownership interest, they will most likely be able to pay an amount less than the price paid by the objecting co-owner for his fractional interest in the property.

Resale by an individual tenant-in-common as §1031 property

Consider a syndicator who seeks to bring together several property owners and cash investors to form a group to co-own an income-producing property located by the syndicator. They will take title as **tenants in common**, each for their fractional share of undivided ownership, based on the pro rata value of their contribution to the purchase price.

The entire property is or will be leased to a single tenant. The tenant will be either a single user of the property or a master tenant with the right to sublet portions of the premises. Either way, the lease is a triple-net lease which imposes no responsibility on the co-owners for maintenance of the property or the supplying of any tenant services.

The co-ownership agreement places no restrictions on each co-owner's ability to sell or encumber their individual TIC interest. Also, **no voting** is established to sell, release or encumber the whole of the property. Thus, any *alienation* of the entire ownership of the real estate requires **unanimous approval** of all the co-owners — the essence of the conduct required to avoid the status of a tax partnership.

Based on these co-ownership arrangements, the syndicator requests of the IRS an **advance ruling** stating the arrangements for the TIC investment do not establish the investors as tax partners or members in an entity. On receipt of the IRC ruling, the fractional interest of a co-owner vested as a tenant-in-common can be acquired or sold as like-kind property.

Thus, an investor's acquisition of a fractional interest in a TIC investment group (with §1031 monies) which is the subject of an IRS advance ruling that the group is not a tax partnership allows the profits an investor realizes on the sale of his property to qualify for the §1031 profit tax exemption by buying replacement property. [Rev. Proc. 2002-22]

To receive an **advance ruling**, the syndicator of a TIC co-ownership arrangement must, as a minimum, present extensive documentation to the IRS. In particular, the syndicator must demonstrate the following conditions exist:

1. Title will be vested in the name of all co-owners as tenants in common as to their fractional or percentage ownership based on their proportionate contribution to the purchase of the property.
2. The co-owners will share in the income, profit and losses based on their percentage ownership.
3. No more than 35 participants will be co-owners, husband and wife are considered as one.
4. The co-owners will not file a joint partnership return, will not operate the property under a common business name, and the co-ownership agreement will not classify the co-owners as shareholders, members or partners.
5. The co-ownership agreement may provide for a right of first refusal to anyone (co-owner, manager, syndicator or lessee) to acquire a co-owner's fractional interest should the co-owner decide to sue for a partition and sale of the property. The fractional interest will be sold at a price set as the fair market value of the property at the time the right to purchase is exercised.
6. Any sale, encumbrance, lease, management or release agreement may only be entered into by unanimous approval of all co-owners (and no one related to the investment may hold a co-owner's power of attorney to act on his behalf).
7. Each co-owner may sell, encumber or lease his fractional ownership interest in the real estate without any prior restraints or approvals needed to permit the transfer, and should a transfer occur, a right of first refusal may exist in favor of any co-owner, the syndicator or the tenant to purchase the fractional interest transferred (based on the current market value of the entire property).
8. Any advances made by any other co-owner, the syndicator or manager to cover a co-owner's failure to meet a call for additional funds must be recourse and due within 31 days.
9. A co-owner may grant an option to purchase his interest to anyone. The price to be paid is the co-owner's fractional share of the whole property's fair market value on the date the option is exercised, however, no guaranteed buy out (put option) can be held by a co-owner to sell to anyone involved in the investment or the property.
10. A property manager may be hired for a period of no more than one year, renewable by unanimous agreement of the co-owners. He may be anyone except a lessee of the property, may collect rents, pay expenses incurred for the services to be provided to tenants as part of the rent, make distributions to co-owners from one bank account, prepare annual profit and loss statements for each co-owner's proportionate share of income, expenses, interest and depreciation, place insurance, negotiate leases to be executed only by unanimous approval of the co-owners and receive a fee in an amount comparable to fees received by competitive brokers, but the fee cannot be based on a percentage of distribution to co-owners.
11. No lender providing funds for the investment program may be a related person to the co-owners, the syndicator, manager or lessee.
12. The syndicator may not sell any co-owner an interest in the property for less than the fractional interest's proportionate share of the whole property's fair market value (and services rendered by the syndicator to form the group), and no promotional fee or contribution by a co-owner may be contingent on the financial success of the investment program. [Rev. Proc. 2002-22]

However, in spite of all these threshold arrangements to obtain a ruling, the IRS provides **no rules or guidelines** for the syndicator's actual formation of a group of co-owners outside the confines of a ruling. Further, the IRS provides **no guidance** for their audit on a co-owner's sale or exchange of a fractional co-ownership interest. The IRS only provides a procedure for requesting an advance ruling by a syndicator based on a very limited set of facts.

As a legal complication, an investment program designed to qualify for an advance ruling from the IRS and sold to investors in California most likely creates a risk of loss for the co-owners which is controlled by *California's securities law* and the *Subdivided Lands Act (SLA)*. Ironically, both laws require more

protection for investors than is required by the IRS for the TIC to qualify for an advance ruling regarding the non-partner status of a fractional co-ownership interest sold or acquired in a §1031 reinvestment plan.

Equity sharing co-ownership investment

Now consider an **equity sharing** transaction, called a *shared equity financing agreement* by the IRS. The real estate, a single family residence, will be co-owned by two individuals, generally on the basis of 50:50 proportionate contributions of the cash required for a down payment, closing costs and reserves.

One or both of the co-owners will qualify for a purchase-assist loan or an assumption of the existing loan to pay the balance remaining due on the purchase price.

One co-owner will occupy the property as his principal residence; the other will hold his ownership interest for investment, called a *mixed use property*. Often the investor is a parent of the resident co-owner. [IRC §280A(d)(3)]

The resident co-owner's motivation is to own a home. However, he does not have sufficient cash reserves for the down payment needed to make up the difference between the maximum loan available and the price demanded by the seller. The investor co-owner's motivation is to simply invest in appreciable real estate which will require no management on his part and is likely to turn a profit (on a sale) after three to five years of ownership.

The economic glue holding the two co-owners together is an **option to purchase** which the investor grants to the resident co-owner so he can acquire sole ownership of his residence in the future. The price under the option to purchase the ownership held by the investor co-owner is one-half of the net equity in the property based on the **fair market value** of the property when the option is exercised or the **capital contribution** of the investor, whichever amount is greater.

The price to be paid on exercise of the option to purchase is not pre-set. If it is, the amount of return the investor would receive for his investment would be set, as though he had made a loan. Normal closing costs of a sale and the remaining principal balance due on the loan encumbering the property are first deducted from the property's fair market value before the price is set.

A co-owner's **equity sharing agreement** is entered into calling for these conditions:

1. The resident co-owner will occupy the entire property as a single user under a **triple-net lease** for a term of five years. The rent amount is set at the fair market value for the use and occupancy of the property. The rent is variable (to cover rising costs, interest, etc.), and in an amount sufficient to cover mortgage payments, property taxes, assessments and insurance premiums.
2. The resident co-owner will pay for all other expenses incurred to repair and maintain the property to protect and conserve its value, as well as for services the resident co-owner may require to occupy the property as his residence.
3. The lease will not prohibit the resident co-owner from **subletting or assigning** his interest in the lease.
4. No restrictions will be placed on each co-owner's right to individually transfer his undivided fractional ownership interest in the property by sale, encumbrance or long-term lease, called the *right of alienation*. However, each co-owner holds a right of first refusal to buy the other co-owner's interest should the other co-owner actually exercise his right to alienate his undivided interest. The price paid on exercise of the option is the co-owner's proportionate share of the property's fair market value at the time of exercise of the first refusal right, less normal closing costs for a sale.

5. The property in its entirety can be sold, encumbered or leased for a long term only with the unanimous approval of the co-owners (both agreeing on the initial five-year lease to the resident co- owner).
6. Any income, profit or loss on the operations, sale, further encumbrance or leasing of the property will be shared based on each co-owner's contribution to capital.
7. The co-ownership will file no partnership returns, nor issue K-1 schedules. The investor co-owner will report his proportionate share of the annual income and expenses on his Schedule E and the resident co-owner will report his proportionate share of those expenses which are deductible by the owner of a principal residence.
8. The investor co-owner will be designated as the property manager (or a real estate broker is employed as the property manager) to collect rent from the resident co-owner under the lease, maintain a bank account in his name (not a trade name or common name) for deposit of income and payment of expenses (property taxes, insurance premiums, homeowners' association charges and mortgage payments), and to disburse, at least quarterly, to the co-owners in proportion to their share of ownership, the spendable income remaining after paying operating and ownership expenses.
9. The investor co-owner will grant an option to purchase (call option) to the resident co-owner, exercisable at anytime during the fourth and fifth year of co-ownership by paying the amount of one half of the net equity in the property after deducting the loan balance remaining and customary seller closing costs from the fair market value of the property on the date of exercise, but the amount will not be less than the original capital investment of the investor co-owner in the property.

Should the resident co-owner exercise the option he holds to purchase the property, will the investor co-owner be able to qualify any profit on the sale of his one-half fractional ownership interest in the property for the §1031 profit tax exemption?

Before a quick answer can be given, one more co-ownership fact must be known: How did the co-owners vest title to the real estate?

If the co-owners vest title to the real estate in their individual names as tenants in common, each as to their individual fractional interest the answer is yes. As a tenant-in-common co-owner, the investor's ownership of a fractional interest in the real estate, not a partner's interest in a *tax partnership*, will qualify any profit taken on the sale of his interest for the §1031 exemption.

Here, the capital interest of the co-owners in the property, represented by a fractional share of participation in income, expenses and loan payments, was managed solely to **protect and conserve** the property held for investment. The services rendered to the tenant to meet those objections were established by the lease in exchange for rent. No source of income existed which was related to a **business service** provided to the tenant for an additional charge.

Further, each co-owner was vested as a tenant-in-common and retained their fundamental ownership rights of alienation. As tenants-in-common, the co-owners were unrestrained by the requirement that co-owners must consent to the sale, encumbrance or long-term lease or partition of their individual undivided fractional interest in the property.

Also, unanimous approval was required of the co-owners to sell, encumber or enter into a long-term lease of the entire property. The granting of options to purchase and rights of first refusal do not place a restraint on a co-owner's right to sell or encumber his fractional interest. However, should a co-owner decide to do so, the right of first refusal is triggered and may be exercised by the other co-owners to buy

out the interest acquired, — at a price representing the co-owner's pro rata share of the property's fair market value on the date of exercise.

However, a **tax partnership** exists if restrictions on alienation rights held by each co-owner call for prior consent to a transfer by a co-owner, or an agreement exists for a co-owner to share in the profits of a business-related service provided to a tenant. Thus, the co-ownership would be a tax partnership which is then considered the owner of the property, even if the co-owners vest the title in their names as tenants in common.

For co-owners who are tax partners, the §1031 exemption is available to the entire group of co-owners on the sale of the entire property and the joint reinvestment of the net sales proceeds in replacement property. The same analysis applies to investors organized as a partnership or an LLC.

Qualifying fractional interests as §1031

When the resident co-owner in an equity sharing plan exercises his purchase option to buy out the investor co-owner (or on the investor's resale of his fractional interest to others), the investor co-owner must avoid partner status if he is to qualify the profit on the sale of his fractional ownership interest for the §1031 exemption.

Three viable exit strategies exist, the selection of one being the investor's decision, including:

- an IRC §761-(a) **election** by the co-owners to be treated as non-partner co-owners of separate interests in the real estate, not as co-owners of the partnership they previously established [IRC §1031(a)];
- a **distribution** by the vested partnership, LLC or DBA ("doing business as") to the co-owner, by granting the co-owner a fractional interest in title to the real estate, vested and with the rights of a common law tenant-in-common, for the co- owner's proportionate share of the ownership in the partnership or LLC; and
- a reliance on the co-owner's prior **Schedule E tax reporting** as an individual owner of an interest in real estate and on the stated purpose in the partnership/LLC operating agreement that the entity holds title for the co-owners, and does not own or operate the real estate.

The dilemma of an entity

An LLC or LP entity is typically used in **real estate syndications** to structure the co-ownership by investors of real estate. The use of an entity is both a practical and prudent title holding arrangement.

For example, California's property tax laws cause a **reassessment** of the property vested in an LLC or LP only when more than 50% of the ownership of the partnership is assigned to others by the original members of the LLC/LP.

Conversely, when title for the same co-owners is vested as tenants in common, each co-owner who conveys his TIC interests to others (including other co-owners), triggers reassessment of the fractional portion he conveyed. Thus, property taxes rise on each conveyance of a fractional interest, not just the 100% reassessment when a change of more than 50% of the original ownership in an LLC/LP eventually occurs.

Also, a **voluntary conveyance** or encumbrance by a co-owner of his interest in the property (as required to be allowed without restraint to receive federal non-partner status) may not concern other co-owners. However, a judgment lien imposed by a creditor on a vested co-owner's interest in title and a foreclosure

by way of a judicial sale of the interest becomes an **involuntary conveyance** of the co-owner's interest to another person.

The creditor foreclosing or another party will acquire the debtor's co-ownership interest in the property. On acquisition as the highest bidder, they will in all likelihood file for the partition and eventual sale of the entire property, i.e., a forced sale by a creditor which an LLC/LP vesting avoids.

Another issue for vested co-owners is the release of their names to tenants as required on acquisition or change of management unless they appoint an agent for service of process. An LLC/LP vesting avoids the **public release** of their names since the co-owners are secreted behind a title holding entity they have formed — the LLC/LP vesting — to either own or simply hold title for the co-owners.

Most important of all, the co-owner is *shielded from liability* for any uninsured obligation he may incur as an owner of the property.

Thus, LLC/LP vestings are preferable for those co-owners not concerned about managing their profit tax avoidance when they invest or withdraw their investment from the group.

Acquiring a fractional interest

Consider an investor who sells his ownership interest in §1031 real estate. The investor is either the sole owner of the property or the owner of a fractional interest in property co-owned by a group. The investor has located a replacement property with an equity far greater than the net proceeds from his sale.

The seller of the replacement property is unwilling to sell on terms consisting of a purchase-money note for the balance due the seller after a down payment. Further, the investor is unwilling (or unable) to commit additional cash funds himself.

However, the investor has solicited another investor who will join with him as a co-owner and contribute the additional funds needed to cash out the seller's equity and purchase the property.

A purchase agreement is entered into to acquire the property. On closing, the two investors take title to the property as tenants in common, each as to an undivided fraction of the title in proportion to their contribution of cash toward the purchase.

They enter into a co-ownership agreement to spell out the arrangements they have agreed to between themselves regarding:

- the **management and operation** of the ongoing rental of the property; and
- the management of their **ownership interest** in the property to sell, encumber or lease (long-term) their interests or the entire property.

The co-ownership agreement addresses their **arrangements for management** of the entire property, as well as each individual's management of their fractional ownership interest, as follows:

1. Title will be vested as a TIC.
2. The property will be managed by one of the investors (or a broker) as the property manager for a one-year period with authority to locate tenants, enter into and enforce short-term leases and rental agreements in his own name, provide normal and customary tenant services, repair and maintenance of the property and maintain a bank account in the manager's name for deposits or receipts from the tenants and disbursements for expenses, mortgage payments and distributions to the co-owners.

3. The co-owners will share income, profits and losses in proportion to their fractional ownership share in the property.
4. Each co-owner will maintain separate tax reporting for their share of operating data, cost basis in their ownership interest and depreciation deductions, and will report their income and losses on their Schedule E with no partnership return to be filed.
5. Any sale, encumbrance, long-term lease or property management contract for the property will be unanimously approved by the co-owners.
6. The right of each co-owner to sell, encumber or partition their fractional ownership interest in the property will be unrestrained by any approval or consent by the other co-owner.

An **option to purchase** either another co-owner's fractional interest or the whole property may be granted to a co-owner or the syndicator who packaged the investment program.

Also, a **right of first refusal** may be granted to co-owners (or the syndicator) to be exercised on another co-owner's decision to sell, encumber or partition his fractional interest in the property.

The price paid on the exercise of the purchase rights is a pro rata amount of the fair market value of the entire property based on the co-owner's fractional ownership interest in the property.

Does the co-ownership agreement establish a *tax partnership* which would disqualify the sale of a co-owner's TIC interest from use of the §1031 profit tax exemption?

No! Neither co-owner is entering into a business relationship with any tenant by providing services unrelated to the rent paid for the property, nor are they sharing income received by a third party who is operating a business providing tenants with services unrelated to operating the rental, such as laundry, food, maid service or towels and linens.

Further, as tenant-in-common co-owners, they **unanimously approve** the hiring of a property manager who has authorization to carry out only those managerial steps necessary to operate the rental property, including customary landlord services and the repair and maintenance necessary to protect the property's improvements and conserve the property's value.

Thus, the co-owner has not relinquished his common law right of a tenant-in-common to act independently of the other co-owner to sell, encumber, enter into long-term leases and partition the property. No trade name, no joint operating (bank) account and no partnership agreement have been used or entered into to coordinate any sale, further encumbrance or long-term lease of the property.

The only "pooling" by the co-owners is the capital investment and its income, operating expenses and mortgage obligations of the ongoing ownership. Each co-owner has retained the ultimate property right to unilaterally withdraw from the investment by sale, encumbrance or partition without the consent of the other co-owner.

An alternative available for the vesting of a co-owner's interest is the use of a wholly owned, one-man LP or LLC for the **vesting** of his fractional interest. Title to his interest would be held in the name of his LP/LLC as a tenant-in-common with all other co-owners. Such a vesting for his undivided fractional interest would be considered by the IRS as title held by a *disregarded entity*. [Revenue Regulations §301.7701-3]

As a **disregarded entity**, an individual co-owner's use of his solely-owned LLC for the vesting of his fractional share of ownership would have absolutely no tax impact on the *non-partner status* of the co-owner's undivided interest.

If title to the entire property is vested in an entity such as an LP or LLC, the co-owners' arrangements must be limited so the entity is merely **holding title** for each individual co-owner, as tenants in common. Further, the entity and the co-owners will not file a partnership return (as 10 or less are already excused from doing so). The operating agreement for the LP/LLC needs to establish the entity holding title has no ownership interest in the property, and is acting solely as a trustee holding title for the co-owners. [Rev. Rul. 79-77]

A vesting change to benefit a partner

A multiple-unit, income-producing real estate project is owned and operated by an investment group as an unincorporated association structured as an LP or LLC.

A broker operates the property as the property manager, locating tenants, entering into leases, contracting for routine repairs and maintenance, depositing all rents into his trust account, disbursing funds for payment of operating expenses, mortgage payments and distributing spendable income to the co-owners.

The investment group (10 or less) does not file an IRS 1065 return and a K-1 information statement on annual operating income, expenses, interest and depreciation is not handed to the co-owners, since these filings are not required. [Rev. Proc. 84-35]

Each co-owner separately reports his fractional share of each year's rental operations on Schedule E of his return based on information provided him by the property manager.

One of the co-owners is selling his fractional interest to another co-owner or an outside party.

The price or value the co-owner receives for his fractional interest exceeds his adjusted cost basis remaining in this investment. Thus, the co-owner will take a profit on the sale or exchange, which for tax purposes must be reported, unless *exempt* or *excluded*. [IRC §1001]

While the co-owner desires to get out of the investment, he does not want to report the profit and pay taxes. He needs all the net proceeds from the sale, undiminished by taxes, to invest in his personal trade or business.

The co-owner locates other property which he will acquire for his own account and use as the premises which houses his business.

The property the co-owner wants to buy will be used in the co-owner's *trade or business* (or rented to his corporate business). Thus, the property he will acquire qualifies as §1031 property since it will be *held for productive use* in his trade or business. [IRC §1231]

Editor's note — If the property acquired is rented to the co-owner's corporate business, it will then be a rental classified as §1031 investment property, not §1031 business property. [IRC §1221]

To structure the sale of his fractional co-ownership interest in the investment group as the first leg of a §1031 reinvestment plan, the LLC/LP will convey to the co-owner by grant deed an undivided interest in the real estate equal to the co-owner's percentage share in the partnership.

Thus, a **liquidation** of the co-owner's interest in the partnership occurs as a *distribution in kind* of the partnership asset — conveyance of his pro rata share in title, a non-taxable event. As a result of the conveyance, the partnership becomes a TIC with the prior partner who now holds title to a fractional interest in the real estate as a tenant-in-common. As a tenant-in-common, the co-owner by TIC agreement is given all the rights to alienate his TIC interest, unrestrained, while agreeing to the centralized manage-

ment of the property's maintenance and customary tenant-related services for a short period of time (not more than one year).

Now, as owner of a TIC interest in real estate and no longer a partner in the partnership, the co-owner sells (or exchanges) and conveys by grant deed his newly acquired TIC interest to a third party. The cash receipts of the sale are used to acquire the real estate he has located as the replacement property to complete his §1031 reinvestment plan.

Has the co-owner held ownership to the TIC interest for a sufficient length of time and for the right reasons to qualify the TIC ownership for the §1031 profit tax exemption?

Yes! The co-owner acquired ownership of the TIC interest with **no intention of liquidating** his investment in real estate by "cashing out." Thus, the co-owner held the TIC interest, unrestrained by the need for prior consent from the co-owners on his sale of his interest. The co-owner's only intent is to make money by remaining **continuously invested** in real estate.

The duration of his ownership in any one particular property, such as his ownership of the TIC interest, is not of concern. It is that the ownership must be held either for productive use in a trade or business or for investment. Since it was so held, the continuation of his investment after a sale by acquiring an ownership interest in replacement property (no matter it be for a long or short period of time) demonstrated the intent required to **remain unliquidated** in real estate investments. [**Bolker** v. **Commissioner** (9th Cir. 1985) 760 F2d 1039]

Editor's note — For property used in a trade or business to qualify as §1031 property, ownership must be retained for a period of one year. [IRC §1231]

The §1031 "no holding" period

The duration of a real estate investment needed to qualify for the §1031 exemption is not the duration of ownership of any one particular property. The investment duration (from one property to the next) required to qualify a property as **held for investment** is similar to the concept of "tacking" ownerships to qualify for holding periods required under other laws.

However, the **duration** of the ownership of a particular parcel of real estate which is part of a §1031 reinvestment plan does not determine whether that property is §1031 property. The test for §1031 is whether the ownership, even though temporary, is **reinvested** in like-kind replacement property, i.e., the owner did not cash out.

A co-owner's intent when acquiring ownership of a TIC interest as a non-taxable distribution by an LP or LLC, is to **make money** by owning it as part of the process of reinvesting in replacement real estate on its sale or exchange.

However, the LP or LLC which distributed the fractional interest by grant deed cannot in a related transaction (or series of transactions) become the owner once again of the fractional interest, at least not concurrently. A co-partner can buy the TIC interest and take title to it in his name and hold it as a TIC interest. However, the partnership cannot, in a related or interconnected series of transactions, reacquire the fractional interest distributed to the partner.

If the partnership does reacquire the co-partner's TIC interest distributed by the partnership for a cash payment made by the partnership, the entire series of related transactions is **collapsed**. Then, the co-partner who withdrew from the partnership is considered to have personally received the cash, not the

TIC interest, as a liquidation of his partnership interest since the partnership **paid to re-bundle** the ownership of the whole property in the name of the partnership. [**Crenshaw** v. **United States** (5th Cir. 1971) 450 F2d 472]

The §1031 by a twist of Schedule E

A lack of understanding seems to exist among taxpayers, CPAs and drafters of IRS forms regarding the consequences of IRC partnership classification for fractional ownership interests, 1065/K-1 co-ownership reporting forms, the exemption from filing by partnerships comprising 10 or less members and Schedule E filing by co-owners.

Thus, an **unintended application** of the §1031 exemption from profit tax reporting permits the profit taken on the sale of a fractional interest in a group investment which would otherwise be classified as a *tax partnership* to go unreported.

For example, when co-owners in an investment group file their individual returns, they report the operating data for rental properties on Schedule E, attached to their annual 1040 return. The partnership does not file a return nor provide K-1 reports.

Schedule E lists the co-owners' proportionate share of income, expenses, interest and depreciation separately. No reference is made (unless volunteered) to the aggregate data generated by the combined ownership of the real estate described in Schedule E.

The property data itemized by the individual co-owner on his Schedule E are but an **undisclosed fraction** of the income, expenses and deductions of the property identified on the co-owner's Schedule E. So far, so good during the ownership of the property.

But on the sale of the ownership interest in real estate listed in Schedule E, the IRS does not know (without an audit or a gratuitous disclosure) whether the interest sold is:

- an ownership **interest in a tax partnership** and thus excluded from tax-free treatment [IRC §1031(a)(2)(D)]; or
- a TIC ownership **interest in the asset** itself which, if unrestrained in its alienation rights, qualifies as §1031 property.

Thus, Schedule E fails to request information from the taxpayer on whether:

- the property ownership is connected by arrangement to additional tenant services paid for separate from rent; or
- the interest listed is a fractional interest.

Likewise, the IRS §1031 disclosure form does not inquire into whether the interest sold or exchanged:

- is a fractional interest in property;
- a fractional ownership interest in a partnership which owns the property; or
- a sole ownership interest in the property. [See IRS Form 8824]

Thus, a co-owner's annual reporting of his fractional interest on Schedule E (or F or C), and the sale and replacement of the interest on a §1031 disclosure form, does not trigger automatic audit or disallowance by the IRS. As a result, the exemption from profit taxes declared by the taxpayer is cleared, without a question about the possible tax partner status of the owner whose fractional interest is sold or acquired.

Editor's note — A school of thought holds the view that these deficiencies in the IRS forms produce the result intended by a more friendly and lenient IRS. However, this might not be the case. [Rev. Proc. 2002-22]

Co-owner's guidelines for non-partner tax status

The following is a briefly stated outline containing comments on the parameters of the conduct permitted by tenant-in-common co- owners, their manager, lenders and providers of services that will allow each tenant-in-common co-owner to treat his vested TIC interest in the property as §1031 property which, on a sale and reinvestment, would qualify its profit as exempt from taxes.

1. *The co-owned property*: Must be §1031 like-kind property in the hands of each co-owner, not a partnership, as follows:

    1.1 *Investment property*: Property in which tenant services provided by the co-owners are limited to those services customarily rendered to tenants under standard leasing arrangements.

    - a. *Passive income*: Defined as income derived from rental property, residential or nonresidential, actively managed with rental agreements and short-term leases. [IRC §1221]
    - b. *Portfolio income*: Defined as income derived from master or ground leases or unimproved land. [IRC §1231]

    1.2 *Trade or business property*: Property held for productive use in a business owned by the co-owners of the real estate is a tax partnership. The co-owners share the profits of the business.

2. *Tenants in common vesting*: Not more than 35 co-owners; each co-owner is an individual or a disregarded entity solely owned by an individual, i.e. an inter vivos trust, LP or LLC used by an investor to hold his TIC interest.

    2.1 Partnership (LP, LLC) vesting:

    - a. Title holding entity for the tenant-in-common co-owners as the stated purpose in the partnership or operating agreement. [**Commissioner** v. **Bollinger** (1985) 485 US 340]

3. *Co-owner' s right of alienation*: Each co-owner has unilateral control over his TIC interest, including:

    3.1 *Alienation or partition*: No restrictions are permitted on each co-owner's decision to sell, encumber or long-term lease, such as:

    - a. A co-owner's fractional interest in the property — no prior approval or consent to alienate is permitted.
    - b. The whole property — unanimous approval of all co-owners is required.
    - c. Right of first refusal on any one co-owner's alienation or partition action is permitted at fair market value.
    - d. Purchase (call) option on the sale alienation of a co- owner's interest granted to anyone at fair market value or cost to co-owners is permitted. [Rev. Proc. 79-77]
    - e. Guaranteed buy out (put option) for a co-owner to sell is not permitted.

3.2 Lenders may not participate in the property's operating income, equity increase or resale proceeds.

3.3 All co-owners must share income, profit or loss in proportion to their contribution to capital and on a parity basis — no subordinated interests are permitted.

4. *Property protection and conservation*:

4.1 Care and maintenance of the property by the property manager limited to minor/non-structural repairs and maintenance. [Rev. Proc. 79-77]

a. Structural repairs or construction of improvements require unanimous approval of the co-owners.

4.2 Tenant services customarily provided under lease and rental agreements are permitted to be provided by the property manager as part of the rent.

a. Tenant improvements to ready the property for long-term tenants require unanimous approval of the co-owners.

4.3 Additional trade or business related services provided to the tenants by the property manager for additional charge is permitted, so long as there is no sharing of income with co-owners.

5. Property management operations:

5.1 Co-owners may not operate under any trade name or DBA, or refer to themselves as partners, shareholders or members of a group.

a. Co-owners may not maintain a joint bank account.

5.2 The co-owners may unanimously approve one co-owner as the property manager or hire a broker as the property manager, but a lessee cannot be the property manager.

a. The term of the property manager's employment cannot exceed one year and any renewal or extension requires unanimous approval by the co-owners.

b. The property manager may be authorized to locate tenants and enter into short-term lease and rental agreements, and enforce the agreements in his name by eviction and collection of rent.

5.3 The property manager's fee to be comparable to fees paid managers of similar properties.

a. The management fee cannot be based on net income or distributions to co-owners, or be subordinated to distribution to co-owners.

5.4 The property manager may, in the manager's name, but not in a common name for the co-owners:

a. Enter into service contracts to provide customary tenant services normally required by lease and rental agreements, and undertake repairs and maintenance necessary to protect and conserve the property.

b. Maintain a bank account for the deposit of rents, disbursements for expenses, payment of mortgages and distribution to co-owners of net spendable income.

c. Place insurance.

d. Hire a resident agent or manager.

e. Prepare profit and loss operating statements reflecting for each co-owner his proportionate share of income, expenses and interest.

6. Tax return/filings with IRS

6.1 No partnership return will be filed.

6.2 Each co-owner will report their share of income, expenses, interest and depreciation on their Schedule E attached to their 1041.

6.3 On a change of vesting from a partnership or LLC to tenants in common, and termination of reporting as a partnership, file for a §761(a) election out of partnership treatment for a distribution in kind, as required of §1031(a) 2.4 to conduct themselves as common law tenant-in-common co-owners.

Chapter 52 Intra-family transfers avoid reassessment

This chapter presents the use by children of the exclusion, held by their parents or grandparents, from reassessment on a child's acquisition by sale or gift of property conveyed to them by their parents or grandparents.

Exclusion for gifts and sales

An older couple owns residential income properties which are unencumbered by mortgage debt. They would like to rid themselves of the management and are considering selling the rentals. The sales proceeds would be reinvested in interest-bearing notes and bonds. The situation is discussed with their children, who live near and have had experience in all aspects of managing the properties while getting their formal education.

The children express an interest in acquiring the properties as investment income for themselves, taking on the management their parents no longer want.

The parents, having already reviewed their situation with a real estate agent they have confided in for years, now discuss the possibility of selling the properties to their children with the assistance of the agent. The parents desire a fully documented and arm's-length arrangement with their children at a price arguably below the current fair market value of the property, and without a down payment in cash. The parents do not want their children to use their cash to buy the properties. The broker expands the discussions to include the possible sale of the parents' principal residence to one of the children who lives locally and could use a larger home for his family.

The parents are intrigued by the broker's comments on the ability of their children to become the owners of the properties without reassessment on the property tax rolls to current fair market value.

One of the properties has a market value of $1,100,000. Conveying the property to an investor would be a *change of ownership* triggering reassessment of the property to its current *full cash value* — $1,100,000. The property's present assessed value is $500,000, which comprises a $325,000 full cash value on the date purchased by the parent (during the recession of 1974-75) and a maximum annual inflation adjustment during their ownership of 2% per annum, compounded. While the taxes now paid by the parents are $5,000 annually, a buyer on acquiring the property would be paying $11,000 annually in taxes since the property would be reassessed at current market prices (full cash value).

The children, on the other hand, qualify to acquire the property without reassessment. Each parent has a separate *exclusion* from reassessment on the transfer to their children of properties covering **current assessed values** up to $1,000,000. Thus, the parents hold a combined exclusion of $2,000,000 in assessed values which can be retained on a sale or gift of properties to their children, without regard to the far greater current fair market values of the properties conveyed.

Thus, the broker points out the children, on buying the apartment building, would continue to pay the same property taxes the parents would be paying, without reassessment and an increase in taxes. The children would save $6,000 in property taxes during the first year alone by buying their parents' properties rather than acquiring a comparable property of the same value from another seller. Each year thereafter the amount of tax savings would increase, since the 2% annual inflation adjustment is on the current

assessed value ($500,000), and would not be based on the current fair market value of $1,100,000 plus the annual 2% inflation adjustment on that amount.

Further, the current property taxes are 5% of the gross rental income. A comparable property of the same value, or the purchase of the parents' property by a non-family member, would cause the taxes to rise, requiring over 10% of the gross rental income to be expended on the payment of property taxes. Here, the purchase by the children will increase their net operating income by $6,000 the first year, providing an extra cushion against any downturn in the local economy which might increase the rate of vacancies and turnover of tenants.

As for the parents' principal residence, a separate exclusion without any assessed value limitation (and of course no fair market value limitation) allows a child of the parents to acquire the parents' residence without reassessment. The child is permitted to take over the parents' assessment since the property is the principal residence of the parents. Thus, the annual cost of owning the residence will not increase on conveyance to the child, as it would if any other person bought the residence.

The parents quickly conclude it is financially advantageous to keep the properties within the family, especially since they have good reason to believe their children have the temperament and ability to operate the rentals successfully.

The broker's duties will include assisting and advising in preparing a purchase agreement; setting an agreeable price; setting the terms of payment of the price by obtaining a purchase-assist mortgage or using a carryback note with an acceptable rate of interest; dictating escrow instructions; and assisting with the change of ownership report to be filed with the assessor by the children on taking title. It is the report to the assessor which will set forth their claim of exclusion for reassessment, since each parent has a $1,000,000 assessed value exclusion available for the child to claim.

Assessed value

Local property taxes are imposed and collected according to the real estate's assessed *full cash value* on the date of acquisition (change of ownership), as adjusted annually for inflation up to 2%. The higher the assessed value, the greater the tax.

Specifically, local taxes are limited to one percent of the property's assessed value for the fiscal year (July 1 to June 30). [Calif. Constitution, Article 13A §1(a)]

A property's **assessed value** for setting the lien for the upcoming fiscal year's property taxes is its *full cash value* as of:

- March 1, 1975, plus a 2% maximum annual adjustment for inflation [Calif. Revenue and Taxation Code §110.1; Calif. Const., Art. 13A §2(b)]; or
- the date sold, improved or other change of ownership after March 1, 1975, plus the 2% maximum annual inflationary adjustments thereafter. [Calif. Const., Art. 13A §2(b)]

Accordingly, property today is only reassessed when its ownership is changed or it is improved by construction or sustains a casualty loss which goes unreplaced. Also, temporary annual reductions occur if the property's fair market value drops below the current assessed value.

Since setting the assessed full cash value of all taxable (non-exempt) properties in 1975, real estate market values have increased significantly beyond the 2% inflation cap for annual *adjustments* to the properties' originally assessed full cash value. An owner of real estate benefits, property tax-wise, by retaining his ownership of the property since the property's operating costs (property taxes) over time are

less than under new ownership or than would be experienced by owners of comparable properties which have recently changed ownership.

This ceiling on property taxes during ownership is a feature which induces owners to retain their properties, rather than sell and acquire new ones.

Consequently, two neighbors owning adjacent properties with identical market values often pay vastly different sums as taxes on their properties, depending on when they acquired their properties. Hence, the "Welcome stranger" attitude of local governmental authorities.

Before discussing the parent-child exclusions from reassessment on a "change of ownership," it is necessary to first review what activities constitute a "change of ownership" and thus trigger reassessment to current market value.

Change of ownership

To trigger reassessment, a *substantial* change of ownership must occur.

A *change of ownership* occurs when the owner transfers a **present interest** in the real estate which:

- includes the *beneficial use* of the real estate; and
- has a value substantially *equal to a fee interest*. [Rev & T C §60]

Every person acquiring an ownership interest in real estate must file a **change of ownership report** with the county assessor on a form provided by the assessor. On the change of ownership report, the buyer indicates whether an exemption or exclusion applies.

Unless the transfer is *exempt* from any assessment or *excluded* from reassessment, the real estate interest conveyed must be reassessed at its current full cash value, typically represented by the price paid by the new owner.

An **exemption** from assessment indicates the property is not considered taxable, such as real estate owned by:

- local, state or federal government;
- churches and religious organizations;
- universities and colleges; and
- charities and nonprofit hospitals. [Rev & T C §§201; 214]

An **exclusion** arises when the property under the new ownership is taxable, but the transfer to the new owner does not trigger reassessment. Thus, the prior owner's full cash value assessment, plus the annual adjustments for inflation, remains as the assessed value for the new owner. [Rev & T C §§69.5; 201.4; 202; 203; 205.5]

Frequently, the terms "exemption" and "exclusion" are carelessly used interchangeably. However, for transfers of privately-owned real estate to avoid reassessment, the new owner must depend on an **exclusion** by filing a claim with the assessor on the change of ownership report at the time of the conveyance or within the period of limitations.

Excluded transactions

While most transfers of title trigger reassessment, some do not. For example, a mere change in the vesting used by an owner or owners to hold title to a property they own is not a *change in ownership*. How-

ever, the proportional interests held by the co-owners before they changed their vesting must remain the same after the transfer.

Changes in vestings from joint tenants to tenants-in-common, or community property, or to the co-owner's partnership or corporation are excluded, so long as the share of ownership held by each co-owner remains the same in the new vesting.

Also, transfer of a partner's interest in a partnership, such as an assignment of a partner's interest, which does not alter the control of the partnership, will likewise not trigger reassessment of the real estate owned by the partnership. [Rev & T C §64(a)]

A **change in control** by partners of a partnership which triggers reassessment occurs when more than 50% of the ownership interests held by the partners in the partnership are sold. This high percentage of change in ownership is one of the benefits for several persons holding title in a limited partnership or LLC. [Rev & T C §§64(c); 25105]

Conversely, when a fractional interest in the vested ownership on title of the real estate is transferred, such as the transfer of an interest held as a tenant-in-common with others, that fractional ownership interest transferred is reassessed. [Rev & T C §65.1(a)]

However, when a vested owner sells less than a 5% interest valued under $10,000, it is not reassessed. [Rev & T C §65.1(a)]

However, do not attempt to exploit two exclusions in the same related series of transfers, the end result of which would have been a reassessment without the exclusion, since the multiple steps will be collapsed into one step and the property interest conveyed will be reassessed. [**Crow Winthrop Operating Partnership** v. **County of Orange** (1992) 10 CA4th 1848]

Intrafamily transfers

Transfers between spouses, called *interspousal transfers*, are also excluded from reassessment. Thus, the current assessment remains in place after the transfer between spouses. [Rev & T C §63]

Transfers between husband and wife are not considered changes in ownership which trigger reassessment if the transfer:

- adds a spouse to title;
- reports the death of a spouse; or
- settles a divorce. [Rev & T C §63]

Also, the transfer of a principal residence and up to $1,000,000 in assessed value of other real estate from a parent to their child or from a child to their parent is not considered a change in ownership which triggers reassessment. [Rev & T C §§63.1(a)(1),(2)]

The parent/child exclusion works either way — applying to transfers from *parent to child* or from *child to parent*. [Rev & T C §63.1(c)(1)]

Generation skipping on death of a child

Occasionally, grandparents lose a son or daughter by death, leaving the grandchildren as their direct descendants. For grandparents who wish to pass on their principal residence or other properties to the children of their deceased son or daughter, whether by sale or by gift, the principal residence exclusion

and the $1,000,000 assessed value of other property are available to avoid reassessment on the transfers. Thus, generation skipping is available to pass on the assessed value of property the grandparents now deed to their surviving grandchildren.

However, a grandchild who has already been deeded the principal residence of their parent (now deceased) and avoided reassessment on the conveyance by claiming the parent's principal residence exclusion cannot now also receive a principal residence of the grandparent and claim another principal residence exclusion from reassessment. This bar against a grandchild receiving another property under a principal residence exclusion applies only to the generation skipping on the death of the child of the grandparents.

However, the $1,000,000 reassessment exclusion held by the grandparents can be used to exclude the transfer of the grandparents' principal residence to the grandchild from reassessment by treating it as other property.

Further, the $1,000,000 exclusion from reassessment held by each grandparent for conveyances to family members is first reduced by any prior allocation of the $1,000,000 to transfers of property to their children. The exclusion amount is further reduced by any prior allocation on conveyances to grandchildren (after the death of the parent/grandparents' child). The remaining amount of the exclusion is then further reduced by any amount of the deceased parent's (grandparents' child's) $1,000,000 exclusion claimed by the grandchild to avoid reassessment of properties sold or given to the grandchild by the deceased parent. Thus, the grandchild is not going to get more from the grandparents than the remainder of the $1,000,000 exclusion unused and held by their deceased parent.

Also, the grandparents cannot sell or give their principal residence to their grandchild and then, on the same transfer, make a claim to carry forward the assessed value of that principal residence to a replacement principal residence of equal or lesser value acquired in an attempt to also use the 55-or-older principal residence exclusion. [Rev & T C §63.1(d)(1)(B)]

Who qualifies

The **parent-child exclusion** only applies to transfers between *parents* and *children*. [Rev & T C §63.1(a)(1)]

A "child" includes a parent's:

- natural child [Rev & T C §63.1(c)(3)(A)];
- stepchild or the stepchild's spouse [Rev & T C §63.1(c)(3)(B)];
- son-in-law or daughter-in-law [Rev & T C §63.1(c)(3)(C)]; and
- adopted child. [Rev & T C §63.1(c)(3)(D)]

A child does not include:

- a natural child who has become the adopted child of another parent [Rev & T C §63.1(c)(3)(A)]; or
- a child who was adopted after turning eighteen years of age. [Rev & T C §63.1(c)(3)(D)]

Each parent and child has **two reassessment exclusions**:

- the transfer of his *principal residence*; and
- the transfer of $1,000,000 assessed value of his *other property*. [Rev & T C §63.1(a)(1),(2)]

Principal residence

To exclude the transfer of a principal residence from reassessment, the parent or child conveying their principal residence to the other must have been granted by the assessor and must now hold either:

- a *homeowner's exemption*; or
- a *disabled veteran's residence* exemption. [Rev & T C §63.1(b)(1)]

Conversely, the child or parent acquiring the property **need not occupy** the property as their principal residence to file a claim with the assessor for the reassessment exclusion to avoid reassessment.

After the transfer, the child or parent receiving the property can use it for any purpose, including a rental.

Interestingly, no assessed value limit exists on the principal residence exclusion. The residence can be worth any dollar amount, be assessed at any dollar amount, and still be transferred from parent to child, or child to parent, without reassessment.

The parcel that includes the **principal residence** is limited to the portion of the land surrounding the improvements which is used for dwelling purposes, separating the acreage used for other purposes from the portion containing the residence, called *apportionment*. [Rev & T C §63.1(b)(1)]

For example, a residence on a large parcel is subject to an apportionment of the acreage on transfer. A ranch, grove or subdivisible acreage transferred with a residence are examples requiring apportionment. The parent or child may transfer any number of their principal residences over the years under the principal residence exclusion. However, the dwelling must qualify as their "principal residence" by having been granted a homeowner's or disabled veteran's exemption at the time transferred.

Here too, parents transferring their principal residence to a child and using their principal residence exclusion, or the $1,000,000 other property exclusion, to avoid reassessment on the conveyance to the child **cannot also use** their 55-or-older assessment carry-forward on the parents' purchase of a replacement principal residence of equal or lesser value than the value of the residence transferred to the children. Only one type of tax relief is permitted on the transfer of the parent's principal residence.

$1,000,000 assessment exclusion

Parents and children can transfer to each other all *other real estate*, without concern for the transfer of their principal residence, up to $1,000,000 of current assessed value without triggering reassessment. [Rev & T C §63.1(a)(2)]

Each child and *each parent* has a separate $1,000,000 assessed value exclusion. When the real estate transferred by the parent or child has an assessed value under $1,000,000, the property is transferred without reassessment. [Rev & T C §63.1(b)(2)]

Likewise, if there are a number of properties, *all* will be excluded from reassessment when their total assessed values is under $1,000,000. [Rev & T C §63.1(b)(2)]

Parents can combine their separate $1,000,000 exclusions to jointly convey property for a total combined exclusion of $2,000,000. Also, children can combine their individual exclusions on the conveyance of their jointly-owned properties to their parents. [Rev & T C §63.1(b)(2)]

However, parents *cannot* combine their exclusion with a child's to deed to another child. To qualify for the $1,000,000 other property exclusion, the transfer must be from parent to child, or child to parent

— not child to child, for which there is no exclusion. Parent to parent transfers must qualify under the *interspousal exclusion* to avoid reassessment.

Now consider a parent who uses his entire $1,000,000 exclusion to transfer property to one of his children. He cannot later transfer property other than his personal residence to another child without reassessment. To treat each child equally regarding the benefit of the intra-family $1,000,000 reassessment exclusion, the parent may allocate a pro rata amount to each child as transfers occur, retaining the unused portion of the $1,000,000 exclusion for future transfers to other children.

Allocation of exclusion to land or improvement

The assessed value of the real estate owned by a parent and transferred to a child might exceed the amount of the $1,000,000 exclusion the parent has remaining or has allocated to the transfer for the child to claim.

The child receiving the real estate that is assessed for an amount exceeding the amount of exclusion available to him needs, as a practical matter, to allocate the exclusion he is entitled to claim, either to:

- the land only;
- the improvements only; or
- both land and improvements.

When using the dollar amount of exclusion available, an allocation of the dollars should be made first to the portion of the real estate which has most appreciated in market value, be it the land or the improvements. The objective is to avoid reassessment of the portion which has inflated most in value over the assessed value.

When the percentage increase in the value of the land is greater than the percentage increase in the value of improvements after the property has been acquired by the parents, the child should allocate the exclusion first to the land since any reassessment of the land will result in higher taxes than will be paid on a reassessment of the improvements.

If any amount of unused exclusion remains, it should then be applied to the improvements.

Conversely, when the percentage increase in the value of the improvements exceeds the percentage increase in the value of the land, the child should first allocate the available amount of exclusion to the improvements.

The reassessment is reduced by applying the exclusion first to the portion of the real estate which has increased at a higher rate. For example, a parent transfers to his child a ranch with an assessed value of $1,500,000 ($1,000,000 to land (two-thirds) and $500,000 to improvements (one-third)).

The ranch's current market value is $8,000,000 ($6,000,000 to land and $2,000,000 to improvements).

The value of the land has appreciated to $5,000,000 (500%) while the improvements have appreciated to $1,500,000 (300%).

If the child allocates the exclusion based on the assessor's ratio, then $667,000 is allocated to the land, and $333,000 to the improvements. The balance of the assessed value ($500,000) for one-third of the property will be reassessed to reflect the current fair market value of one-third of the entire property, which is not sheltered by the parent-child exclusion.

Thus, one-third of the current value of $8,000,000 is added to the $1,000,000 assessed value retained under the exclusion. Accordingly, the ranch's new assessed value will be $3,670,000 ($1,000,000 plus $2,670,000). Here, the child in this example can minimize his property tax liability by selectively allocating the exclusion only to the land.

Selective allocation

In our example, the child should allocate the full $1,000,000 exclusion to the land since the value of the land has increased at a higher rate than the value of the improvements. The land will not then be reassessed as it is fully sheltered by the available amount of exclusion. However, the value of the improvements will be reassessed at current market value, its *full cash value*. Here, the ranch's new assessed value on reassessment of only the improvements will be $3,000,000 ($1,000,000 plus $2,000,000). The child minimizes the amount of future property taxes by selectively allocating the total exclusion to the land. The child shelters an additional $670,000 of current market value from reassessment by selective allocation, rather than using the assessor's ratio of land and improvement values.

Filing a claim

To qualify for the principal residence or the $1,000,000 exclusion, the parent or child receiving property must file a claim for the exclusion with the assessor. The claim should be filed with the assessor when recording the deed, noted on the change of ownership report form supplied by the assessor. The assessor, in turn, tracks the parents' and children's exclusion amounts through the California Franchise Tax Board. The Franchise Tax Board acts as a clearing house to monitor the total exclusion amounts claimed by each property owner.

If the parent exceeds the $1,000,000 exclusion ceiling, then the last conveyance will be reassessed and only the unused portion of the exclusion which remains will be granted. The balance of the real estate's assessed value not excluded on transfer from reassessment will be reassessed for its pro rata share of the property's full cash value at the time of the transfer.

Final considerations

The parent-child $1,000,000 reassessment exclusion on a transfer does not cover real estate owned by the parent or the child which is vested in an LLC, partnership or corporation. [Rev & T C §63.1(c)(6)]

Where title is held in a family partnership or corporation, the property should be first deeded back to the parents before deeding it to the children under the exclusion. The two steps must be completed in separate, unrelated transfers, preferably in different fiscal years, to avoid the collapsing of a two-step transaction into one step, which would lead to reassessment. [Rev & T C §63.1; **Shuwa Investments Corporation** v. **County of Los Angeles** (1991) 1 CA4th 1635]

The child can, in turn, transfer the property into his own partnership or corporation without reassessment. Again, the second transfer must be totally unrelated to the first transfer.

However, parent-child transfers to and from an inter vivos trust are excluded from reassessment. [Rev & T C §63.1(c)(9)]

No restrictions prevent the parent or child who conveys the property from continuing in occupancy of the transferred property. Also, the transfers need not take place as part of estate planning — although most probably do.

The transfer to the child can occur at any time.

The parent-child exclusion is an encouragement for families to retain ownership of their real estate rather than sell and obtain replacement property which will be reassessed.

For brokers, this will mean fewer sales of investment-quality real estate, due to the owner's ability to keep the real estate in the family and enjoy lower property taxes than if the real estate were acquired by others.

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